Economic & Strategy Research

December 21, 2006

CEZ

Hold (3-6m)
Update

Valuation

Price at 20/12/2006 (PSE)

CZK 942.1

12M Fair value

CZK 1,002

Societe Generale sector weighting: Underweight

Previous recommendation: Buy, target CZK 889 (February 22,2006)

Don´t get overexcited!

- **Investment case 3-6m: We are downgrading our 3-6 month recommendation from Buy to Hold, though we have raised our fair value from CZK 889 to CZK 1,002.** CEZ´s strong performance in recent months has exhausted its short-term growth potential in our view; we see no further ST catalyst. Any additional upside depends mainly on re-leveraging, which we believe is a remote prospect as CEZ is forced to bank mainly on new power plant constructions in its expansion drive due to a lack of acquisition targets and strong competition in tenders. Construction of new power plants will take 5-7 years including preparation and will not improve CEZ´s results before their completion. CEZ will not be privatized in the next few years and cannot thus be acquired, which lowers the appeal of its shares because a possible acquisition premium cannot be factored into CEZ´s share price unlike some of its European peers (M&A activity has become the main driver of the sector´s valuations in recent months). CEZ shares are valued with little discount to its peers on 2008 estimates and continue to offer a lower dividend yield, which provides little argument to buy the stock in the ST. CEZ still faces significant unresolved risks related to: 1) the necessary power plant renewal, which has become increasingly complicated due to the current political situation and increased role of the Greens in Czech politics (CEZ needs to either enlarge Temelin or get the coal mining limits extended to be able to replace all its coal power plants, otherwise its above-average profitability could be threatened in the LT), 2) the sub-optimal output at Temelin (our valuation includes an increase in the output of existing nuclear power plants - if this is not achieved the negative impact is close to CZK 40 per share). The utilities sector in Europe will face regulatory risks from the EU next year and is expensive, trading with a 25% premium to the average market valuations based on 2008 P/E estimates.

- **12m fair value: CZK 1,002 based on DCF (up from the previous CZK 889)**

- **Next event:** 2006 results announcement (February 23, 2007). We expect CEZ to exceed moderately its revised guidance on profit from CO2 trading. The results of foreign subsidiaries will be important for the stock (the Q3 results of Polish producers were a negative surprise), as well as the scope of further cost savings and the impact of Temelin shutdowns in Q4.

Share data			
52-week range (CZK)			565.5– 1,010
Market cap. (CZK bn / USD bn)			557.7 / 26.9
Free float (%)			32.4
Reuters			CEZsp.PR
Bloomberg			CEZ CP
Performance (%)	**1m**	**3m**	**12m**
Ordinary shares	3.4	20.0	28.6
USD	8.6	29.7	49.9
Rel. PX	1.3	9.9	18.4

Financial data	2005	2006e	2007e	2008e
Revenues (CZKbn)	125.1	157.9	184.0	199.2
EBITDA margin (%)	40.1	40.7	41.2	42.3
Rep. net income (CZKbn)	21.5	27.7	35.5	41.6
EPS (adj.) (CZK)	33.4	46.7	60.0	70.3
Gross dividend (CZK)	15.0	20.5	26.5	31.1
Interest cover (x)	13.5	19.1	24.8	27.7
Payout (%)	45.1	43.8	44.1	44.3
Net debt/equity (%)	12.4	18.1	8.8	0.4

Year to 31 Dec EPS CAGR 05-08e: 28.2 %

Ratios	2005	2006e	2007e	2008e
P/E (x)	15.6	20.2	15.7	13.4
Price/cash flow (x)	7.5	10.9	9.4	8.4
Gross yield (%)	2.9	2.2	2.8	3.3
Price/book value (x)	1.7	2.9	2.5	2.3
EV/revenues (x)	2.9	4.0	3.4	3.0
EV/EBITDA (x)	7.3	9.8	8.1	7.1
EV/IC (x)	1.5	2.2	2.1	2.0

2005 avg. daily vol. USDm: 49.3 CZKm: 1,180.8

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Summary

We are downgrading our 3-6 month recommendation from Buy to Hold, though we have raised the fair value from CZK 889 to CZK 1,002. The main factors contributing to the higher target price include the higher expected LT electricity price (EUR 50 instead of previous EUR 48), the faster increase of Czech prices towards the German level (in our previous analysis we expected a 15% growth of power prices for 2007, the actual increase is faster), Varna power plant acquisition and lower WACC, while the longer period of estimated Czech currency appreciation and problems at Temelin had a negative impact on the valuation. CEZ´s strong performance in the last few months has exhausted its short-term growth potential in our view; we see no further ST catalyst and therefore revise our 3-6 month recommendation to Hold. Any additional upside depends mainly on re-leveraging, which we believe is a remote prospect. The amount of cash free for acquisitions in the sector in Europe is estimated by Societe Generale at EUR 100bn by the end of next year, increasing competition for acquisitions and driving up valuation of acquisition targets. CEZ is thus forced to concentrate mainly on new power plant constructions in its expansion drive, which means slower re-leveraging and slower improvement of results than via acquisitions. The construction of new power plants will take 5-7 years including preparation and will not improve CEZ´s results before their completion. CEZ will not be privatized in the next few years and cannot thus be acquired, which lowers the appeal of its shares in the sector. M&A activity has become the main driver of the sector´s valuations in recent months. CEZ cannot be acquired for the time being and valuation of its shares should thus not contain any acquisition premium unlike some of its European peers. CEZ shares are valued with limited discount to its peers on 2008 estimates and continue to offer a lower dividend yield, which provides little argument in favour of buying the stock in the ST. CEZ still faces significant unresolved risks related to: 1) the necessary power plant renewal, which has become ever more complicated due to the current political situation and the higher profile of the Greens in Czech politics (CEZ needs to either enlarge Temelin or get the coal mining limits extended to be able to replace all its coal power plants, otherwise its above-average profitability could be threatened in the LT), 2) the sub-optimal output at Temelin (our valuation includes an increase in the output of existing nuclear power plants - if this is not achieved the negative impact is close to CZK 40 per share). We do not expect these risks to be removed over the next six months. The utilities sector in Europe will face regulatory risks from the EU next year and is expensive, trading with a 25% premium to average market valuations based on 2008 P/E estimates. Due to the strong performance of emerging markets in the last six months, a profit-taking is quite likely sometime during H1 2007, which could negatively influence CEZ´s share price.

The company

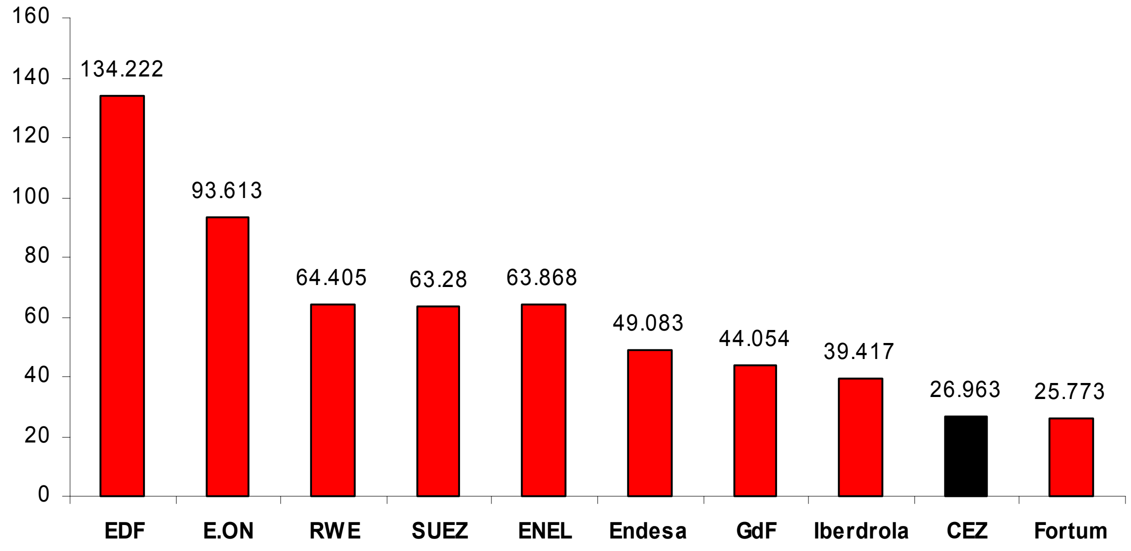
CEZ is the largest company by market capitalization in the new EU countries.

The company has a 73% market share in electricity production in the Czech Republic, a 62% market share in electricity distribution in the Czech Republic and following the acquisition of Severoceske Doly a 45% market share in the Czech coal mining market. Czech competition in production is weak in relation to CEZ. The distribution market is split between CEZ (5 distributors) and E.ON (2 distributors), with EnBW figuring as a minority investor in the only independent distributor (controlled by the City of Prague).

CEZ is actively seeking acquisitions in the CEE region. Following the acquisitions of distributors in Bulgaria and Romania, the company has a 42% market share in the Bulgarian distribution market and 17% in the Romanian distribution market. Recent acquisitions in Poland give the company a 2.3% share of the Polish electricity production market. The company has recently acquired the Varna power plant in Bulgaria and is actively seeking acquisition and expansion opportunities throughout the CEE region.

CEZ is the second largest Czech company in terms of sales and the largest in terms of NI. CEZ is one of the top ten European electricity utilities in terms of both its number of customers and market capitalization.

The top 10 continental European utilities by market cap. (USDbn)



Source: KB calculations, Reuters

2007 results – CEZ publishes a conservative guidance below market consensus estimates.

CEZ announced its 2007 target of EBITDA CZK 69.4, EBIT CZK 47bn and NI before minorities of CZK 34bn.

Our estimates are higher than CEZ´s guidance (EBITDA of CZK 75.8bn, EBIT of CZK 51bn and NI before minorities of CZK 37.04bn). The company usually sets conservative targets so it can raise raise them during the year; however, this means CEZ will only gradually raise its guidance towards the market consensus of estimates during the year, which is not good news for the stock in the ST.

Electricity prices are stable for now, above LT sustainable levels.

German 2008 FWD baseload electricity prices (EUR/MWh)

Source: Reuters

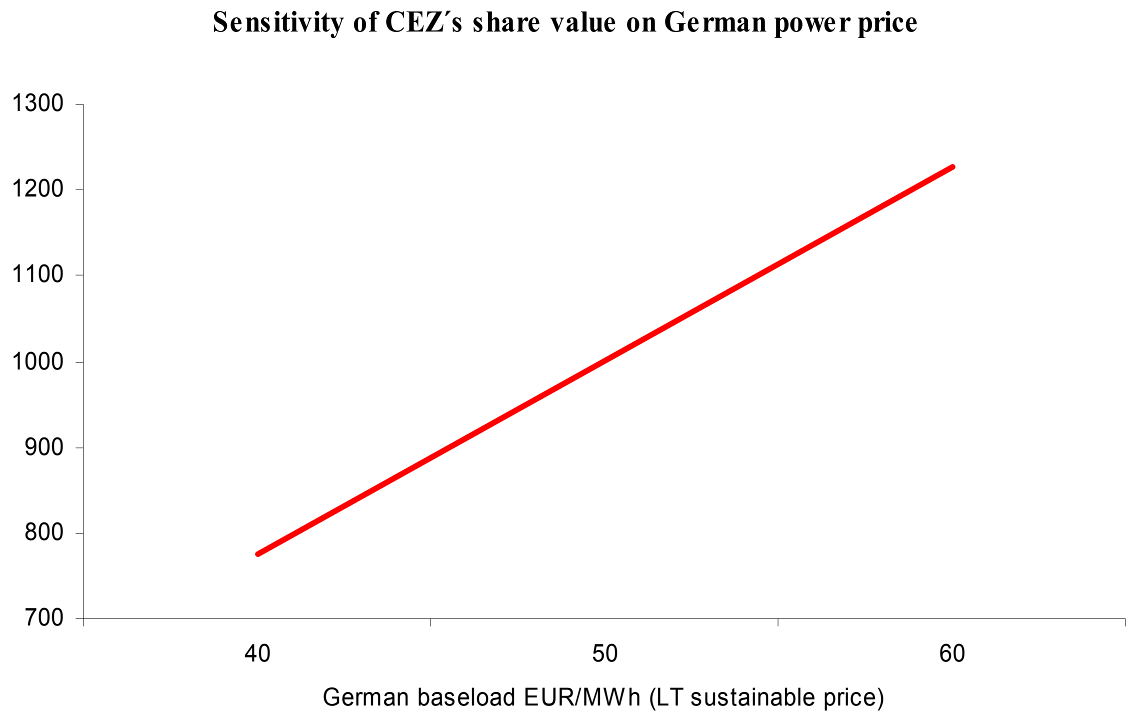
German forward baseload electricity prices have stabilized in 2006 at around EUR 55 per MWh. Our valuation is based on the LT electricity price of EUR 50 per MWh (an increase from the previous estimate of EUR/MWh 48). We expect German and European electricity prices to drop by 2010 towards EUR/MWh 50 for the following reasons:

1) The development of new gas fields in the Persian Gulf and the expansion of LNG trading will broaden gas supply in Europe, integrate world gas markets and cut gas prices and therefore marginal costs of electricity production from 2008 / 2009.
2) The large number of new power plant projects driven by current high profitability in the sector will lower the current supply / demand squeeze after 2010 and will contribute to lower power prices in Europe.

Czech wholesale power prices will increase 16.9% y/y on average in 2007. We expect further growth by 7.5% in 2008, though this growth will only be temporary and will be reversed in further years as German prices start falling and the CZK keeps strengthening. After the convergence of power prices in the region to the German price, CEZ will be a price-taker and its prices will be derived from German price levels and CZK development.

CEZ is more sensitive to electricity price developments (and assumptions) than most its peers because its production costs are less related to electricity price developments than at its peers (CEZ does not operate gas power plants, its coal prices are only partially related to electricity prices).

The following chart shows the sensitivity of CEZ´s share value on the LT sustainable level of electricity prices:



Source: KB calculations

LT CZK appreciation is negative for CEZ.

Once Czech power prices converge to German levels (which we expect by 2009), the LT appreciation trend of the Czech currency will have an adverse effect on Czech power prices measured in the Czech currency. The delay in expected Eurozone entry for the Czech Republic will prolong the period of Czech currency nominal appreciation – we now assume till 2012, substantially reducing the space for a further LT increase in wholesale power prices in the Czech Republic.

Assuming a wholesale German baseload price of EUR 50 in 2012 and CZK/EUR of 25.4 in this year, the wholesale power price could reach CZK 1,270 per MWh in the Czech Republic, leaving only very limited space for further LT growth of wholesale power prices from 2007 levels). Czech power prices will likely overshoot in 2008 but the prevailing opinion that Czech wholesale power prices will grow quickly for several further years is flawed in our view.

Uncertainty concerning power plant renewal remains a major threat to CEZ, unlikely to be resolved soon.

CEZ has to renew its aging coal power plants during the next 10-15 years. The decision on power plant renewals has been taken only concerning part of CEZ´s existing power plant portfolio. Therefore, uncertainty currently persists over the future CAPEX needs and the cost characteristics of CEZ´s production.

This decision is connected with the amount of lignite available for mining in the future. Lignite at the two main producers (Severoceske Doly and MUS) can currently be mined only within approved mining area limits. If the limits are not enlarged, CEZ will be able to renew only 45% of its current coal PPs. Enlargement of the mining limits would enable CEZ to renew 70% of its lignite-burning PPs. Enlargement at MUS is more important for CEZ as the deposits of MUS outside current mining limits are larger and the lignite is of a higher quality. This enlargement is fiercely opposed by environmentalists, village inhabitants, as well as by the Greens, which are playing an increasing role in Czech politics. There is no guarantee the limits will be extended. Enlargement of the limits would be good news for CEZ. The decision over the enlargement will be taken by the regional administration of north Bohemia, not by the central government. The region´s governor has expressed opposition to the enlargement in the past. CEZ and the coal miner MUS have concluded frame agreements on coal supplies till 2050. MUS is nevertheless likely to seek improvements in coal supply terms after the existing contracts expire in six years.

Another possibility for CEZ, which we still consider the most likely and therefore include in our model, is the construction of a nuclear PP. We assume construction of an additional 2000 MW at Temelin. From the outset, the Temelin site has been planned for four reactors, currently it has two. All political parties, except for the Greens, as well as a majority of the population are in favour of extending Temelin.

CEZ has double the EBIT margin of the average of European utilities (30% versus 15%). One of the main reasons for this is the lower production costs at its lignite and nuclear power plants, which give CEZ a high competitive advantage. If approval is not granted for either new nuclear power plants or extended coal mining limits, the negative impact on CEZ could be substantial. Cheaper power plants would have to be replaced by gas power plants or coal power plants built outside the Czech Republic, which could be built not only by CEZ but also by its competitors. Production costs would increase while power prices would remain unchanged as Czech power prices will be determined by the larger German market. This would lead to an erosion of CEZ´s profitability and competitive position. We do not expect this risk to be eliminated quickly.

Temelin outages to reduce 2007 results.

CEZ has recently announced an additional shutdown at Temelin will be necessary next year on the first unit, which will last for almost two months. The output at Temelin will thus remain deeply sub-optimal next year. CEZ has already sold its output for next year, i.e. it will have to replace the output with more expensive coal power plants or external power purchases. The negative impact of expected lower production in nuclear power plants on CEZ´s EBITDA is close to CZK 1bn in our estimates.

CEZ presented plans to gradually raise the output at its nuclear power plants by 4.2 TWh annually thanks to reducing unplanned as well as planned re-fueling outages over the next years and technology CAPEX to raise production capacity. We included these plans in our valuation. If this is not achieved, the value of CEZ´s shares would be almost 4% lower. We see the outages at Temelin as a risk for CEZ in the future.

Re-leveraging: a remote prospect in our view.

CEZ´s indebtedness remains low compared to the industry standard and CEZ thus has a space for upside via change in capital structure and re-leveraging. CEZ could spend approximately EUR 7bn on acquisitions or buybacks thanks to its free cash flow generation and re-leveraging potential. Re-leveraging could be reached by several means; CEZ has preferred expansion over payments to shareholders:

1) Acquisitions – The utilities sector in Europe has excess cash for acquisitions in the amount of EUR 100bn by end-2007 (based on Societe Generale´s estimate); all major companies are excessively cash-rich and keen to expand via acquisitions. Many predators are thus chasing increasingly scarce prey, driving valuations up. Privatizations have slowed down in Poland and Romania, further limiting possible acquisition targets for CEZ in CEE. Re-leveraging via acquisitions in a large extent is thus very unlikely in our view as CEZ is not willing to overpay for acquisition targets. ENEL has been the strongest competitor in acquisitions in CEE. The lack of suitable acquisition targets and fierce competition in tenders has forced CEZ to broaden its target territory to include more risky regions and to concentrate on new power plant construction. Bloomberg has just reported the Czech Deputy Industry Minister as saying that CEZ terminated the negotiations for the acquisition of distributors in

Ukraine on disagreement over price; this was the only major acquisition negotiation where quick progress could have been achieved.

2) New power plant constructions – This is the method CEZ has been increasingly relying on. The disadvantages are the timing of the projects (the preparation of the projects, obtaining all permits and construction will take 5-7 years, i.e. re-leveraging will be a lengthy process) and the fact that most of the projects will not improve CEZ´s results until completed, i.e. a limited positive contribution to EBITDA can be expected for the next up to 8 years. This is why we do not expect a quick positive impact on share price from these projects. Via new projects, CEZ could indeed reach the targeted re-leveraging gradually in the next five years with a positive impact on its results in the LT. The first such project is the Gecko power plant in the Serbian part of Bosnia, where CEZ plans to invest EUR 1.5bn in the construction of new 600-700 MW power plant, the extension of mines and the modernization of the existing 300 MW power plant. CEZ will hold a 51% stake in the project, which could prove profitable in the long-term period as CEZ could export power from this plant to Greece and Turkey. CEZ is taking part in a tender for 2100 MW power plant construction in Kosovo together with AES (CEZ is competing with two other consortia and seven other companies for this project) and is considering power plant construction in Serbia (Kolubara B), Moslim-Croat part of Bosnia, Romania, Turkey and Russia.
3) Dividends – CEZ has recently set a dividend policy aimed at a dividend payout of 40-50%, which is not sufficient for re-leveraging. We do not expect CEZ to breach its newly-established dividend policy.
4) Share buybacks – CEZ is interested in buying shares in CEZ, which will likely be sold by the government next year (some 5-7% of share capital).

Dividend yield will remain below the industry standard.

CEZ has recently unveiled its dividend policy of a 40-50% dividend payout (slightly below current industry average of 52%). Our dividend expectations are based on an assumption of dividends near mid-range 45% payout.

CZK	*2006E**	*2007E*	*2008E*	*2009E*	*2010E*
DPS	20.5	27	31.1	33.3	34.6
Dividend yield %	2.2	2.8	3.3	3.5	3.7

*=dividends from 2006 profits, approved and paid in 2007

Source: KB estimates

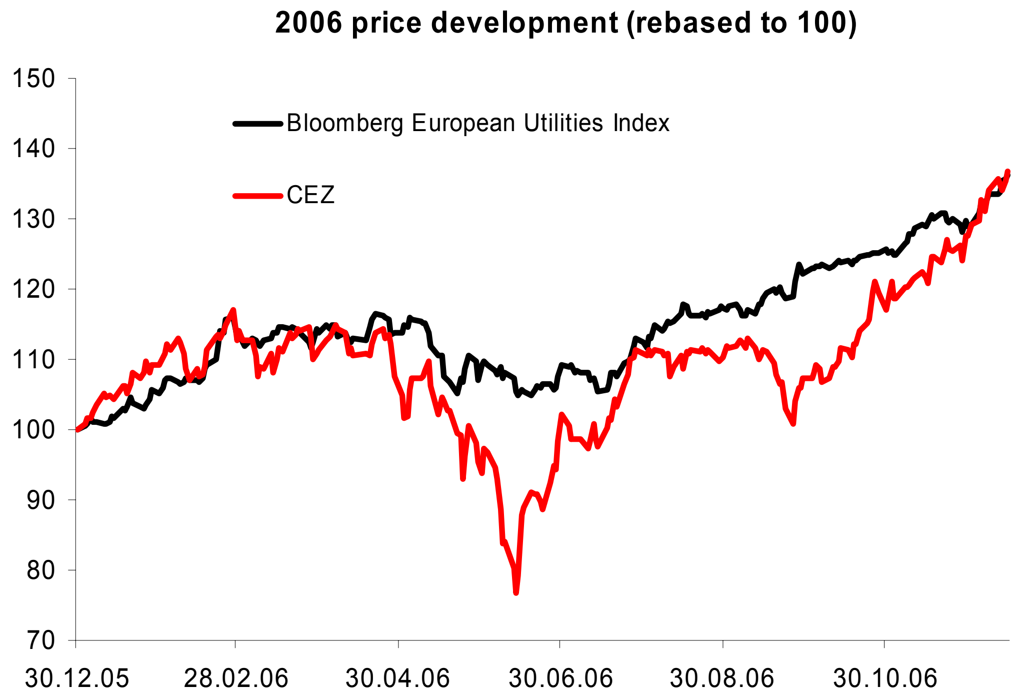
The average expected dividend yield of European utilities for 2008 currently currently stands at 3.8% based on SG estimates, i.e. above the yield provided by CEZ.

Privatization of CEZ unlikely soon – upside via an acquisition premium is limited.

With acquisition premiums of around 20% in the sector at the moment, a decision to launch privatization of CEZ would be highly positive for CEZ´s share price; however, we do not expect privatization in the next few years. The leaders of the three main political parties agreed in December not to sell CEZ before 2010. Although this agreement was a part of failed government negotiations and is thus no longer valid, we do not expect any change in this stance among the main political parties.

Therefore, we expect CEZ to be left out as an acquisition target in the ongoing M&A party in the industry in the mid-term. CEZ´s share price therefore should not factor in any possible acquisition premium, which lowers CEZ´s valuation. Acquisition speculations have driven industry valuations up and are currently the main remaining driver of growth in the sector.

The fact that CEZ cannot be acquired for the time being significantly lowers the appeal of the stock in the sector comparison as investors are likely to concentrate their interest on possible acquisition targets. This has been evident in 2006, when CEZ´s shares barely matched the development in the Bloomberg European Utilities Index in spite of the faster-than-expected growth of electricity prices in the Czech Republic for 2007 and several acquisitions. CEZ underperformed the index development for most of the year and was able to catch up only at the end of the year thanks to the demand from Polish pension funds following CEZ´s dual listing on the Warsaw Stock Exchange. As M&A activity will be the only remaining driver of the utilities sector in 2007 and acquisition targets could be the main gainers, CEZ´s outperformance of the utilities index seems unlikely next year.



Source: Bloomberg, the PSE, KB calcullations

Sector – cautious outlook for 2007.

Power prices have stabilized and will no longer be the driver of the sector´s performance as power prices should gradually start falling with cheaper gas supplies to Europe. The sector in Europe is expensive as it trades at a 25% premium to average market valuations based on 2008E P/E (15.4 vs. 12.3 for the market based on Societe Generale estimates), while traditionally there used to be no premium for the sector at all. This limits the scope for further outperformance of the sector after several strong years. The focus of investors is likely to shift from generation companies towards safer regulated assets (CEZ has a below-average share of regulated distribution business in its EBITDA of only around 20%). The planned measures by the EU to foster competition in the sector pose some risks for future years, though protracted discussions on the proposals are likely and the sharpest proposals, such as the forced ownership unbundling of distributors, are likely to be watered down in the approval process. M&A will likely remain the driver of the sector´s performance, though to a lesser extent than has been the case this year.

Societe Generale´s sector recommendation for European utilities is Underweight (underweight as valuation and regulatory risks are high).

Regulatory risk for CEZ is below average of the sector on strong political support.

CEZ is controlled by the government and therefore there is an obvious risk of political interference into the company´s operations. So far, CEZ has been able to build up strong political support across the parties, with the exception of the Greens, which are playing an increasing role in Czech politics. Czech government members have lobbied for CEZ´s interests in privatizations in Poland and Bulgaria as the government is promoting the idea of CEZ as a "national champion". Opposition to double-digit wholesale power price increases has been on the rise; nevertheless, political support is likely to continue. Both main political parties CSSD and ODS support nuclear power plant expansion. We see regulatory risk for CEZ as below the sector average; from this viewpoint CEZ belongs among the more attractive stocks in the sector.

The EU will present its proposals to boost competition in the sector. One of the proposals, the ownership unbundling of distributors, would be bad news for CEZ, which has benefited from vertical integration with distributors in the last years. We are, however, sceptical that this proposal will be approved. The proposals may have a negative impact on the whole sector at the beginning of next year.

Risks

Investors in CEZ shares face several risks:

1) CEZ shares could decrease significantly if there is a decline of electricity prices on European markets. Our valuation is based on a LT sustainable electricity price of 50 EUR after 2010 and market overshooting in the next few years (see the chart above for our estimate of sensitivity on power prices).
2) Electricity prices have become more volatile, which has increased the risk profile of the electrical utilities sector and CEZ in particular due to its above-average sensitivity to electricity price. The growing beta can have a negative influence on valuation of the sector in the future. Utilities are no longer a defensive investment due to increased riska and high valuations.
3) Discount rates used for valuations of shares in the CEE region may rise, negatively influencing most stocks in the region, incuding CEZ. Risk premiums for emerging markets are currently at record-low levels and the market has grown quickly in the last six months. Profit-taking in emerging markets is thus likely during the next six months, with negative impact on Czech stocks including CEZ.
4) CEZ intends to increase capacity in its nuclear facilities and raise capacity utilization especially at Temelin. If this is not achievable (if Temelin´s problems persist), value of CEZ shares would be lower by approximately 4%).
5) Our valuation contains considerable cost savings. It is not certain they will be reached by the management.
6) We have assumed that the CZK will strengthen to CZK/EUR 25.4 by 2012. A faster appreciation of Czech currency would be negative for CEZ as the effect of the lower growth of Czech electricity prices measured in CZK (derived from German power prices in EUR) and lower export proceeds would far outweigh the profits from a decrease of value of CEZ´s foreign debt.
7) Our valuation is based on an unchanged number of emission allowances allocated to CEZ and on their market price of EUR20 in 2008, EUR 23 in 2009-12 and further growth to EUR 29 by 2020. A reduction in allowances would probably increase electricity prices, which would limit the possible negative impact on CEZ. The allocation of CO2 allowances for the next period has not been fixed yet.
8) There is considerable uncertainty connected with the renewal of CEZ´s production facilities. The amount and timing of future investments and cost characteristics of the future production sources is not fully certain at the moment (a decision on renewal of the remaining part of the aging coal PPs has been delayed by political uncertainty). CEZ has above-average profit margins thanks to its low-cost production base, which may not be LT sustainable.
9) The energy sector is regulated. It is not certain the regulators will always be as forthcoming to CEZ as they are now. A further set of regulations will likely be presented by the EU in the next months.
10) CEZ is still a state-owned company. Decisions of the majority shareholder, which would have a negative impact on the value of CEZ, cannot be excluded.
11) Further upside for the stock is dependent on re-leveraging. This may not be achievable if there is not enough acquisition targets.
12) Due to increasing competition in foreign acquisitions, CEZ has been forced to become more aggressive in bidding, to consider acquisitions in more risky countries and to concentrate on LT projects of new power plant construction. If the acquisitions are overpaid or projects face cost overruns, this would lower CEZ´s share value.
13) CEZ is traded at a premium to other European utilities based on historical and near future valuation multiples. The premium can partly be justified by higher growth and re-leveraging opportunities; however, there is no guarantee that the market will consider this level of valuation premium as acceptable in the future.

Valuation

We have used the DCF model up to 2020 to estimate the fair value of CEZ shares. We discounted the projected cash flows to 9/2006 using WACC of 7.8% and a long-term growth rate of 1.5%.

The WACC calculation is based on a 4% risk-free rate, beta of 1.1 and equity risk premium of 5% and expected LT structure of 25% debt, 75% equity (i.e. assuming partial releveraging).

We have used an LT growth rate of 1.5% after 2020, lower than our usual 2-3% for two reasons: 1) the primary reason is that CAPEX is below depreciation in the base year for perpetuity, which is clearly unsustainable till infinity, 2) the secondary reason is that CEZ´s cost advantage is also not sustainable till infinity (cheap coal reserves).

Based on our model, we estimate the fair value of CEZ's shares to be CZK 1,002 per share The stock is highly sensitive to WACC, i.e. higher re-leveraging could raise the value further.

Calculation of DCF fair value	
WACC	7.8%
LT growth rate	1.5%
Terminal value	1 156 520
Cumul PV of CF	290 592
PV of terminal value	367 072
PV of EV	657 664
Less net debt	(64 329)
Equity value	593 335
Number of shares (m)	592.21
DCF value per share (CZK)	**1,002**

Source: KB Estimates

Sensitivity analysis

The following table provides a snapshot of the sensitivity of CEZ's fair value to changes in WACC and long-term growth rate.

Growth	**WACC**	**6.8%**	**7.3%**	**7.8%**	**8.3%**	**8.8%**
0.5%		1 126	1 010	912	827	754
1.0%		1 191	1 062	954	861	782
1.5%		1 268	1 122	**1 002**	900	814
2.0%		1 360	1 194	1 059	946	850
2.5%		1 475	1 281	1 126	999	893

Source: KB Estimates

Sector comparison We have also looked at the sector comparison with leading European electricity utilities. CEZ shares are traded with a premium over the 2006 sector average, turning into a discount on 2008 estimates. This is caused by the faster growth of CEZ on equalization of Czech power prices with Germany. We expect CEZ to provide a dividend yield below the sector average. Sector valuations have been boosted by increased M&A activity in the last 12 months; this lowers CEZ´s attractiveness as the company cannot be acquired for the time being (it will remain majority state-owned also in the next few years). CEZ is thus traded on par with the sector, which supports our Hold recommendation as the sector comparison offers no impulse to buy CEZ´s stock in the next 3-6 months. CEZ has above average profitability, the unresolved power-plant renewal poses a risk for the company in the LT. The utilities sector is traded on record valuation, which limits the upside for the sector as a whole.

	Yield (%)			EV/EBIT			P/E		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
E.ON	3.2	3.7	4.3	10.9	10.4	9.6	15.8	14.0	12.9
EDF	*2.0*	*2.1*	*2.5*	14.9	15.2	13.6	25.4	23.6	20.3
Endesa	*2.2*	*2.3*	*n.a.*	16.0	15.5	n.a.	22.5	22.2	n.a.
ENEL	*6.3*	*6.5*	*6.7*	11.2	10.9	11.0	15.8	15.4	14.9
Fortum	*3.0*	*3.3*	*3.6*	15.8	13.5	12.5	18.6	15.7	14.7
Iberdrola	*3.1*	*3.4*	*3.7*	16.1	14.8	14.0	18.8	16.8	15.4
Verbund	*1.5*	*1.7*	*1.8*	19.9	17.4	16.2	27.0	22.5	21.1
EnBW	*2.2*	*2.6*	*3.0*	n.a.	n.a.	n.a.	20.6	18.3	16.9
EVN	*1.6*	*1.6*	*1.7*	25.0	24.1	22.9	*16.5*	*18.4*	*16.8*
RWE	*4.2*	*4.8*	*4.6*	13.6	11.0	10.7	18.5	15.5	14.8
Suez	*5.6*	*3.2*	*3.7*	15.2	12.4	10.8	20.7	16.6	14.6
Average (continental Europe power)	3.2	3.2	3.6	15.9	14.5	13.5	20.0	18.1	16.2
SG average of European utilities*	*3.4*	*3.4*	*3.8*	13.7	12.6	11.6	18.9	17.2	15.5
CEZ	**2.2**	**2.8**	**3.3**	**15.8**	**12.1**	**10.3**	**20.2**	**15.7**	**13.4**

* Incl. gas, multi-utilities, UK
Source: Societe Generale, KB estimates

Utilities / Czech Republic

Price at 20/12/2006

CEZ

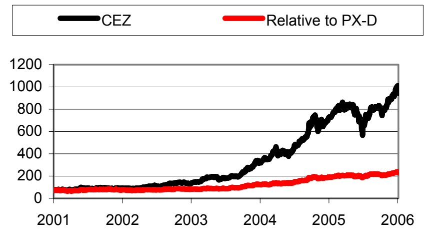
CZK 942.1

Update

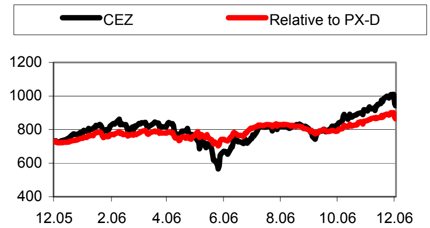
Year to 31 December	**2002**	**2003**	**2004**	**2005**	**2006e**	**2007e**	**2008e**
Valuation*							
P/E (x)	6,1	7,7	9.6	15.6	20.2	15.7	13.4
Price/cash flow (x)	2,6	2,7	3.8	7.6	10.8	9.3	8.3
Price/free cash flow (x)	5,1	3,4	7.3	-428.2	46.2	19.7	16.9
Price/book value (x)	0,4	0,4	0.7	1.7	2.9	2.5	2.3
EV/revenues (x)	2,0	1,6	1.8	2.9	4.0	3.4	3.0
EV/EBITDA (x)	4,8	4,4	4.8	7.3	9.8	8.1	7.1
Gross yield (%)	5,2	6,9	4.2	2.9	2.2	2.8	3.3
Per share data (CZK)							
EPS (adj.)	14,2	15,0	22.3	33.4	46.7	60.0	70.3
Goodwil amortization	0,0	0,0	0.0	0.0	0.0	0.0	0.0
Cash flow	34,1	43,7	55.8	68.4	87.5	101.8	113.8
Book value	243,4	258,0	290.6	298.4	330.0	369.6	413.3
Gross dividend	4,5	8,0	9.0	15.0	20.5	26.5	31.1
Income statement (CZKm							
Revenues	55578	84816	102 670	125 083	157 903	183 977	199 183
EBITDA	22 975	29 965	39 627	50 157	64 202	75 806	84 178
Depreciation and amort. (ex.GW amort.)	-11 721	-16 961	-19 842	-20 737	-24 145	-24 758	-25 778
EBITA	11 254	13 004	19 785	29 420	40 057	51 048	58 399
Goodwil amortization	0	0	0	1 704	0	0	0
Net interest income	-433	-1 395	-1 562	-1 750	-1 379	-1 576	-1 191
Exceptional &non-operating items	975	-872	278	-347	-1 261	-2 279	-2 408
Taxation	-3 375	-1 349	-4 233	-5 025	-8 419	-10 146	-11 508
Minority interests	0	-519	-1 055	-846	-1 335	-1 532	-1 696
Other	0	0	0	0	0	0	0
Reported net income	8 421	8 869	13 213	21 452	27 663	35 514	41 596
Net income excl. exceptionals & GW	8 421	8 869	13 213	19 748	27 663	35 514	41 596
Cash flow statement (CZKm)							
EBITDA	22 975	29 965	39 627	50 157	64 202	75 806	84 178
Change in working capital	163	7 168	5 794	-2 594	803	-4 284	-930
Other operating cash movements	2 311	26 263	-11 459	16 963	7 027	2 212	2 341
Cash flow from operating activities	25 449	63 396	33 962	64 526	72 032	73 734	85 589
Net capital expenditures	-9 614	-50 130	-22 442	-40 632	-43 311	-30 927	-36 217
Cash flow from investing activities	-11 527	-59 083	-32 620	-29 613	-65 483	-31 427	-36 717
Cash flow from financing activities	-10 229	-908	9 103	-19 942	6 813	-17 911	-19 178
Net change in cash resulting from CF	3 693	3 405	10 445	14 971	13 362	24 396	29 694
Balance sheet (CZKm)							
Total long-term assets	216 112	258 234	271 012	279 888	321 226	327 895	338 833
Of which intangible assets	1 174	1 997	3 379	6 057	20 220	20 220	20 220
Working capital	8 643	1 851	14 038	19 631	22 262	23 557	25 449
Shareholders' equity	143 675	152 624	172 097	176 687	195 445	218 848	244 766
Minority interests	0	7 893	6 350	14 618	13 107	14 638	16 334
Provisions	36 407	44 027	45 044	54 420	64 112	66 317	68 652
Net debt (-)/cash (+)	-35 739	-34 962	-32 877	-21 948	-35 363	-19 169	-1 083
Accouting ratios							
Profitability							
ROIC (%)	4.1	4,5	6.5	9.1	11.5	13.6	15.1
ROE (%)	6.0	6,0	8.1	12.3	14.9	17.1	17.9
Margins							
EBITDA margin (%)	41,3	35,3	38.6	40.1	40.7	41.2	42.3
EBITA margin (%)	20,2	15,3	19.3	23.5	25.4	27.7	29.3
Growth rates							
Revenue yoy growth (%)	-1,8	52,6	21.1	21.8	26.2	16.5	8.3
EBITDA yoy growth (%)	-5,3	30,4	32.2	26.6	28.0	18.1	11.0
EBITA yoy growth (%)	-24,5	15,6	52.1	48.7	36.2	27.4	14.4
Reported net income yoy growth (%)	-7,7	5,3	49.0	62.4	29.0	28.4	17.1
Net income excl. exceptionals & GW yoy growth (%)	-7,7	5,3	49.0	49.5	40.1	28.4	17.1
EPS (adj.) yoy growth (%)	-7,7	5,3	49.0	49.5	40.1	28.4	17.1
Financing							
Net debt/equity (%)	24,9	22,9	19.1	12.4	18.1	8.8	0.4
Interest cover (x)	19,3	7,6	8.7	13.5	19.1	24.8	27.7
Payout ratio (%)	31,6	53,4	40.3	45.1	43.8	44.1	44.3

Fair value **CZK 1,002**

5 years



1 year



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* Valuation ratios for past years are based on average historical prices and market capitalizations

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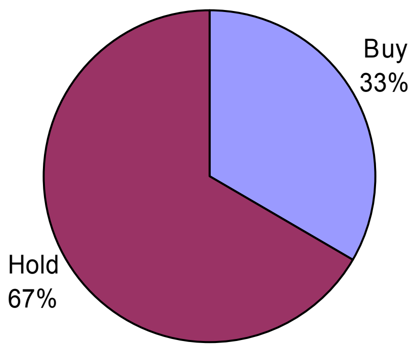
The main methods Komercni Banka uses to set target prices for stocks are discounted free cash flow analysis and sector comparison. Other methods may also be used if deemed appropriate by the analyst (e.g. a sum of parts valuation, discounted dividend valuation, discount / premium to NAV). The target price is set for a time period of 12 months. Komercni Banka applies three grades of investment recommendation: buy, hold and sell. The recommendation is set for the time period of the next three to six months. The most important factor in setting the recommendation is the difference between the actual market price and the target price calculated by KB equity research. The recommendation should also reflect other factors the analyst expects to influence the stock and market in the time period of the next 3-6 months, i.e. target price substantially above current price does not automatically mean a buy recommendation for the next 3-6 months. Key valuation methods and factors in setting the recommendation are explained in the text of each analysis.

The chart below shows the structure of the grades of valid investment recommendations of equity research of KB Economic & Strategy Research (6 recommendations).

Investment recommendations of KB Economic & Strategy Research - equity research (as of 20.12.2006) *



*KB did not provide to issuers investment services of substantial extent

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Disclosure of KB (or related entities´) interests and conflicts of interests as to issuers referred to in the KB investment research and recommendation as of 21.12.2006

	ČEZ		Telefonica O2 Cz. Rep.		CME		Orco		Philip Morris		Zentiva	
Overview of last investment research and recommendation related to stocks of particular issuers*	hold		buy		Hold		hold		hold		Buy	
	Target price CZK 1002 (21.12.2006)		Target price CZK 602 (23.12.2005)		Target price USD 70.2 (18.8.2006)		Target price CZK 2.225 (18.1.2006)		Target price CZK 19.515 (8.2.2005)		Target price CZK 1390 (14.11.2006)	
Overview of investment research and recommendations for last 12M (quarterly)	22/02/05	buy	09/09/05	buy	30/06/05	buy	22/02/05	buy			08/08/06	hold
	CZK	889	CZK	512	CZK	1538	CZK	1374			CZK	1306
Direct or indirect share (5% or more) of the issuer in the registered capital of KB	no		no		no		no		No		No	
Other significant financial interest of KB and/or its related entities in the issuer	no		no		no		no		No		No	
KB direct or indirect share (5% or more) in the registered capital of the issuer.	no		no		no		no		No		No	
Significant financial interest in the issuer of the persons participating in the elaboration of investment researches and recommendations.	no		no		no		no		No		No	

Relationships of Komerční banka (or related entities) with particular issuers

	ČEZ	Telefonica O2 Cz. Rep.	CME	Orco	Philip Morris	Zentiva
Management or co- management of public offerings in the past 12 month	yes	no	no	yes	no	No
Agreements or contractual relations for providing investment services with the issuer.	KB may have concluded agreements with the issuer for providing investment services. This information is protected by bank secret and can not be disclosed.					
Agreement with the issuer on production and dissemination of the research	no	no	no	no	no	no
KB market making** for common stocks of the issuer?	yes	yes	no	no	no	yes

* KB does not provide investment recommendation for its own common stock. Investment recommendation for stocks of Erste Bank are provided by Société Généràle.

** Komerční banka acts as a market maker in the Prague stock Exchange/ SPAD trading system for the stocks of the following common stocks of issuers: ČEZ, Telefonica O2 Czech Republic, Erste Bank, Zentiva, Komerční banka (market making for this stock has been suspended until recall).

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