

## Daldrup & Söhne

### Improving profitability and order backlog

Daldrup & Söhne continues to benefit from regulatory support for geothermal energy in Germany. This is evidenced by its order backlog of €75m to date, sufficient to support its full engineering capacity for all business divisions into 2019. Meanwhile, its geothermal power plants in Landau and Taufkirchen are scheduled to come online before the end of 2017. Management confirmed, in a press release on 4 October, FY17 guidance of €40m in output (revenue plus change in work-in-progress) and an EBIT margin of 2-5% (compared to 2% in FY16). We believe that the company needs to achieve at least 2.5% EBIT margin in order to cover its interest expenses.

### H117 results on track

H117 results indicate that Daldrup & Söhne's is on track to achieve its guidance for the year. Output was €22.8m (up 8.5% y-o-y), EBIT was €0.5m (up 25% y-o-y) and EPS was €0.03 (vs €0.00 in H116). H117 interest expenses of €0.60m were in line with H116, despite an increase in net debt to €8.95m. As Daldrup & Söhne reports according to German GAAP all costs and expenses are recognised when incurred and profitability is based on output (revenue plus change in work-in-progress).

### Landau and Taufkirchen plants to produce electricity

Management is stepping up efforts in project development and ownership with a view to creating predictable revenue streams as an independent power producer to counterbalance the volatility of the drilling/engineering business. The Landau geothermal plant (40% owned by Daldrup & Söhne) is currently running trial operations and commercial production is scheduled by the end of 2017. The Taufkirchen geothermal plant (38.9% owned) is also projected to start producing power before the year end. The revenue/profit contribution from these two plants is not factored into management's guidance for FY17. As of the end of June 2017, both plants are equity accounted.

### Valuation: Trading at a premium to peers

Daldrup & Söhne is currently valued at 74x P/E, 1.5x EV/sales and 39x EV/EBIT based on 2017 consensus estimates, largely trading at a premium to onshore and offshore drilling peers. However, if power starts to account for a significant portion of Daldrup & Söhne's revenue, renewable developers and geothermal specialists may be better comparators.

#### Consensus estimates

Year end	Revenue (€m)	EBIT (€m)	PBT (€)	EPS (€)	P/E (x)	Yield (%)
12/15	17.3	0.8	0.8	0.03	297	N/A
12/16	31.3	1.0	(0.2)	0.03	297	N/A
12/17e	39.7	1.5	0.8	0.12	74	N/A

Source: Company data, Bloomberg

#### Alternative energy

18 October 2017

**Price** €8.9  
**Market cap** €48m

#### Share price graph



#### Share details

Code 4DS  
Listing Deutsche Börse Scale  
Shares in issue 5.445m  
Last reported net debt as at 30 June 2017 €8.95m

#### Business description

Daldrup & Söhne AG is an onshore drilling and environmental services company, with vertically integrated competencies in geothermal projects (from feasibility study, permitting and constructing to power supply contracting). It is seeking to create predictable revenue stream as an independent power producer.

#### Bull

- The favourable feed-in-tariffs for geothermal in Germany until 2020 continue to boost demand.
- Daldrup & Söhne's increasing exposure to project business may improve its profitability.
- Given the additional orders in the pipeline, Daldrup & Söhne may be able to recruit and retain talent to create incremental growth.

#### Bear

- Daldrup & Söhne does not have a history of scaling up significantly, measured by staff size.
- Project development, if too aggressive, may increase the company's leverage.
- Needs to achieve the upper end of the EBIT guidance in 2017 to cover interest burden.

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## H117 results on track; order backlog until 2019

Daldrup & Söhne's H117 results indicate it is on track to achieve its annual guidance. Its H117 output (revenue plus change in work-in-progress) was €22.8m, up 8.5% y-o-y; EBIT was €0.5m, up 25% y-o-y; and EPS was €0.03, compared to €0.00 in H116. Material costs and personnel expenses have increased by 1.7% and 4.1% y-o-y, respectively, in line with growing business activities. Interest expenses dropped slightly, from €0.61m in H116 to €0.60m in H117, despite an increase in net debt to €8.95m in H117. As of 30 June 2017, the company reported cash and cash equivalents of €0.3m (vs €0.8m as of 31 December 2016). Work in progress amounted to €77.2m in H117, an increase of €14.2m from the end of 2016, mostly as a result of unfinished work at construction sites in Belgium and Germany that has not yet been fully invoiced. Advance payments received, amounting to €65.7m in H117 (vs €56.0m in H216), were deducted from orders in progress as is industry practice.

The business environment remains favourable, with regulatory support from the German government for geothermal power, and strong demand for geothermal projects in Belgium and the Netherlands as well. As of 31 August 2017, order intake exceeded €75m (an increase of €10m from 31 May 2017). Daldrup & Söhne is expecting to run at its full engineering capacity into 2019 and will continue to seek new orders for its capacity throughout 2019.

As Daldrup & Söhne reports according to German GAAP, all costs and expenses are recognised immediately when incurred, but profitability is based on output (invoiced revenue plus change in work-in-progress). The inclusion of the change in work-in-progress helps to smooth out the timing difference between revenue recognition and cash flows, as deep-geothermal contracts typically last two years and other projects might be shorter. This means that profitability is likely understated at the beginning of good times, as it is now, and overstated at bad times.

### Exhibit 1: H116 vs H117 results

€m	H116	H117	Y-o-y	Comment
Sales	7.3	5.5	(24%)	
Increase in work in progress	13.7	17.3	26.3%	
Output (sales + change in work in progress)	20.9	22.8	8.5%	Increase in orders and business activities
Cost of materials	(11.7)	(11.9)	1.7%	Cost of materials to output ratio was down to 52.3% in H117 (55.9% in H116)
Personnel expenses	3.8	4.0	4.1%	Staff number increase
EBIT	0.4	0.5	25%	
Amortisation, depreciation and impairment	(1.8)	(1.7)	(2.4%)	
EBITDA	2.2	2.3	4.5%	
Interest expenses	(0.61)	(0.60)	(1.6%)	Flattish interest expenses, despite an increase in net debt
Profit before taxes	(0.041)	0.139	N/A	Improving profits on the back of growing business activities
Income tax benefits	0.043	0.029	(53%)	
Net profits	0.003	0.168	635%	
EPS (€)	0.00	0.03	N/A	Improving profits on the back of growing business activities
Cash flows from operating activities	(0.204)	(1.102)		Primarily due to an increase in payables by €2.4m in H117
Cash flows from investing activities	(0.756)	0.107		No equity investment in H117 (vs €0.684m in H116)
Cash flows from financing activities	(1.174)	0.612		No loan repayment and an increase in loans by €0.612m

Source: Daldrup & Söhne data

## Landau & Taufkirchen plants to produce power in Q417

The amended renewable energies law (EEG) in Germany, taking effect on 1 January 2017, offers strong regulatory support in the form of feed-in-tariffs for geothermics at €0.252/kWh until 2021 and

5% annual depression after that. The tariff is fixed and paid for 20 years in addition to the year in which operation of the plant begins. Unlike wind and solar, geothermal can serve as a baseload source.

Daldrup & Söhne is stepping up efforts in project development and ownership, in order to create predictable revenue streams as an independent power producer to counterbalance the volatility of the drilling/engineering business. Daldrup is also developing geothermal project pipelines in the Bavarian Molasse Basin in Puchheim (a heat project), near Munich, and the Upper Rhine Rift Valley in Neuried.

## Landau geothermal power plant (40% owned by Daldrup & Söhne)

The Landau plant was temporarily closed (after a leakage in 2014) and valued at €1 in Daldrup & Söhne's financial assets as of the end of June 2017. The first trial operations at the plant started in early October 2017, and are expected to finish at the end of November 2017. Management hopes to start commercial operations by the end of 2017. This power plant has capacity of up to 3.6MW for electricity and up to 7MW for thermal energy. It is worth noting that the Landau plant is on the old feed-in-tariffs of €0.19/kWh. As the plant started production back in 2008, it will attract the feed-in-tariffs for another 11 years.

## Taufkirchen geothermal power plant (38.9% owned by Daldrup & Söhne)

The installed capacity of the Taufkirchen plant is approximately 38MW for thermal energy and about 4.3MW for electricity. The company should be installing the first heat exchanger and starting trial production, which is expected to be concluded by the end of 2017. The second heat exchanger is scheduled to come online in the spring of 2018. This plant has been supplying heat to Taufkirchen and Oberhaching since the end of 2015. Going forward, the plan is to produce more electricity in summer to attract feed-in-tariffs at €0.252/kWh, and more heat in winter to fulfil the contractual obligations with the communities in Taufkirchen and Oberhaching. It is worth noting that the heat production is not covered by the EEG.

## Valuation

Daldrup & Söhne is currently valued at 74x P/E, 1.5x EV/sales and 39x EV/EBIT based on 2017 consensus forecast of revenue and net debt forecast (at €4.3m), largely trading at a premium to onshore/offshore drilling peers. It is worth noting that Daldrup & Söhne only undertakes onshore projects and the majority of its competitors are also active offshore. As offshore drilling capabilities serve the oil and gas industry, the economic drivers and regulatory environments are rather different from the geothermal sector. That said, Daldrup & Söhne competes with these companies for onshore drilling contracts.

**Exhibit 2: Peer group comparison – onshore/offshore drilling**

	Market cap	P/E (x)		EV/sales (x)		EV/EBIT (x)	
	(m)	2017e	2018e	2017e	2018e	2017e	2018e
Daldrup & Söhne	€50m	76.75	38.38	1.49	1.23	39.40	25.69
Odjell Drilling	€644m	29.05	25.37	3.07	3.03	19.16	20.39
Songa Offshore	€814m	14.01	10.37	4.41	4.42	13.39	12.92
BAUER	€437m	17.57	12.65	0.71	0.69	14.75	12.15
<b>Peer group average</b>		<b>20.21</b>	<b>16.13</b>	<b>2.11</b>	<b>2.71</b>	<b>15.77</b>	<b>15.15</b>

Source: Bloomberg. Note: Prices as at 9 October 2017.

A more appropriate group of peers for Daldrup & Söhne in the long run is perhaps independent renewable EPC/developers with their main operations in Germany and the rest of the Europe, given

the similarities to their exposure to regulatory risks. Most such companies are focused on wind and solar, and have gone through a few cycles as a result of demand/supply dynamics and regulatory changes (from fixed feed-in tariffs to auction-based pricing). Compared to solar and wind, geothermal power in Germany is still at an early stage of development. On the positive side, the geothermal sector is less susceptible to the pressure of oversupply (as in the case of solar and wind) and pricing pressure, because of a much more complex and elongated process in permitting, exploration and engineering. On the negative side, investors are less likely to see exponential growth in a short period of time for geothermal companies due to the technical entry barriers and risks and the long development cycle (five years in Germany). It is also worth noting that specialist project developers tend to have a high level of gearing. The high EV/sales multiple for 7C Solarparken is partly due to its net debt of €156m (vs FY17e consensus forecast of revenue of €32.5m and EBIT of €11.6m).

Finally, geothermal companies operating across the supply chain may also shed light on Daldrup & Söhne. For instance, Ormat Technology owns and operates 676MW geothermal projects (mostly in the US), and sells its power generation equipment and engineering services. Approximately one-third of its revenue is from the sale of electricity and two-thirds from the sale of products. The entry barrier to geothermics is significantly higher and this is reflected with higher valuations of Ormat Technology compared with independent wind/solar developers in Europe.

**Exhibit 3: Peer group comparison – renewable companies**

	Market cap	P/E (x)		EV/sales (x)		EV/EBIT	
	(m)	2017e	2018e	2017e	2018e	2017e	2018e
7C Solarparken	€108	19.20	19.51	8.15	7.89	22.84	20.80
Energiekontor	€226	19.51	19.76	2.21	2.08	10.05	9.18
Good Energy	£35	27.40	15.86	0.94	0.80	15.01	12.69
Ormat Technology	\$3,068	25.99	24.13	5.73	5.35	17.86	15.87
<b>Peer group average</b>		<b>23.90</b>	<b>19.79</b>	<b>4.25</b>	<b>4.03</b>	<b>16.44</b>	<b>14.64</b>

Source: Bloomberg. Note: Prices as at 10 October 2017.

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