Metals&Mining | Poland

Company update

KGHM

Buy (from Neutral)

TP: PLN 107

- Rating upgrade to Buy from Neutral with 12M TP down to PLN 107
- We expect 2016E net profit of PLN 1,982m
- 2016E P/E 9.3x with DY 4.1%

Vestor DOM MAKLERSKI

equity research

4 November 2015

Copper bottoming, tax relief offers upside

We are upgrading our rating on KGHM to Buy from Neutral, trimming our 12M TP to PLN 107 from PLN 109. We believe risk/reward has significantly improved. First, copper prices may be bottoming out as concerns about China have arguably eased, and global supply/demand outlook improved; ICSG is expecting a 127kt global deficit in 2016. Second, the new government formed by the PiS party is likely to temporarily abandon or reduce the Metal Exploration Tax (MET). Full abolishment of the MET would increase our DCF by PLN 51/per share at spot prices. Assuming a 19% effective decrease in the MET (CIT deductability) in 1Q16 we expect KGHM's net profit at PLN 1,982m in 2016E, rising to PLN 2,291m in 2017E. On our new estimates KGHM is trading at P/E of 9.3x and 8.1x for 2016-17E, respectively, with an above-average discount to peers. We expect DPS of PLN 3.8 in 2016E, which implies DY of 4.1%.

Copper market in deficit in 2016? Copper fell 19% YTD dragged down by concerns about China and fear of oversupply. Nevertheless, after major miners announced production cuts, in its October report, ICSG has switched its 2016E global balance estimate to 127k tonnes deficit from 228k oversupply.

MET relief could be a major upside. Prior to parliamentary elections, Prime Minister candidate B. Szydło promised KGHM the abolition of MET. We've estimated NPV of such solution at PLN 51/per share at the current spot prices. In our base case scenario we assume that economically, MET will be cut by 19%, which increases our 2016E net profit estimate by PLN 260m and adds PLN 10 per share to the valuation. We also note that potential loose monetary policy of the new government may increase the pressure for the PLN to depreciate vs USD which would be supportive for KGHM earnings.

We expect 2016E net profit of PLN 1,982m. Due to PLN 209m expected loss on mark-to-market of the Tauron stake we expect 2015E net profit of PLN 1,869m. Due to lower copper prices (USD 5,140/t) partly offset by the strong USD we expect KGHM's net profit to grow by 6% YoY to PLN 1,982m including 19% ease on MET. Due to growing production from Sierra Gorda (oxide project) and higher copper prices (USUD 5,250/t) we expect 2017E NP to grow by 16% to PLN 2,291m.

Dividend still a support. Despite heavy capex plan we expect KGHM to keep its dividend policy in place as it has secured debt financing for its most important projects. With strong USD supporting parent unit results, we expect 2016E DPS of PLN 3.8, which implies DY of 4.1%, above average in the mining industry.

Valuation. Our new 2016-175E EPS forecast implies P/E of 9.3x and 8.1x with adj. EV/EBITDA multiples at 4.9x and 4.8x, all on massive double digit discounts to its peers, despite higher dividend yields and rich portfolio of mining project incl. Sierra Gorda, Afton-Ajax and Victoria, which will improve cost profile of the KGHM.

Figure 1. KGHM: Financial forecast and valuation

		2013	2014	2015E	2016E	2017E
Revenues	PLN m	24,110	20,492	19,534	20,761	21,262
EBITDA	PLN m	6,174	4,988	4,978	4,623	4,957
EBITDA+ SG	PLN m	6,174	4,988	5,118	5,165	5,648
Net profit	PLN m	3,033	2,450	1,869	1,982	2,291
EPS	PLN	15.2	12.3	9.3	9.9	11.5
DPS*	PLN	9.8	5.0	4.0	3.8	4.0
P/E (x)	x	9.5	11.6	9.9	9.3	8.1
EV/EBITDA**(x)	x	3.9	7.0	4.7	4.9	4.8

*Source: Company data, Vestor DM estimates,*paid in a given year, **EBITDA incl.Sierra Gorda*

Company data

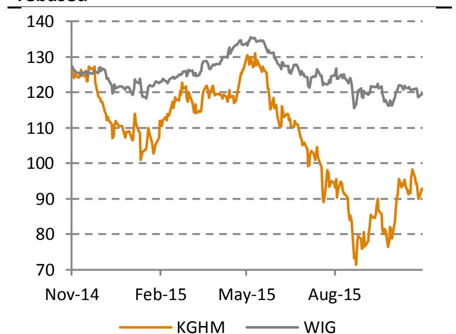
Target Price (PLN)	107
Previous target price (PLN)	109
Share Price (PLN)	92
Upside	16%
Min (52W)	71
Max (52W)	131
No. of shares (m)	200
Market cap (PLN m)	18 460
Net debt 2Q2015 (PLN m)	4 973
EV (PLN m)	23 433
Avg. 3M Turnover (PLN m)	89

Shareholders	%
State Treasury	31.8
Others	68.2

Company description

KGHM is the 10th largest refined copper producer with 571kt output in 2012 (3% global supply). It is also the world's biggest silver producer. The core Polish underground mines extract c.420kt, while in 2012 KGHM diversified to the Americas, buying Quadra FNX. It currently runs the 55% owned greenfield open pit Sierra Gorda project in Chile (230kt target output, 20y LOM, feasible as of 2014). Polish assets are in the 3rd quartile of the global cost curve with Sierra Gorda assumed to fit into the 1st. KGHM aims to expand its own production to 700kt.

KGHM vs WIG 1Yr relative price performance rebased



Source: Bloomberg

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Over last twelve months, Vestor issued one buy recommendation concerning KGHM dated 15th January 2015 with target price 109PLN. Vestor may act as a market maker for the shares of KGHM now and in the future.

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Buy/Accumulate/Neutral/Reduce/Sell – means that, according to the authors of this document, the stock price may perform materially better/better/neutrally/worse/materially worse than the cost of equity of the respective stock.

The recommendation system of Vestor is based on determination of target prices and their relations to current prices of financial instruments; in addition, when recommendations are addressed to a wide range of recipients, two methods of valuation are required.

In preparing this document Vestor applied at least two of the following valuation methods:

1) discounted cash flows (DCF),

2) comparative,

3) target multiple,

4) scenario analysis,

5) dividend discount model (DDM),

6) NAV,

7) Sum of the parts.

8) Discounted residual income model

9) ROE-P/BV model

The discounted cash flows (DCF) valuation method is based on discounting expected future cash flows. The main advantage of the DCF valuation is the fact that this method takes into account all cash streams the issuer is expected to reach and the cost of money over time. From the other hand, DCF valuation method requires a number of assumptions and is very sensitive to changes in parameters used in the in the model. Small changes in inputs can result in large changes in the value of a company.

The comparative valuation method is based on the rule of “one price”. The advantages of this method are small number of parameters that need to be estimated, the fact that there is a relatively large number of indicators for companies being compared, the method is well-known among investors and the valuation is based on current market conditions. From the other hand a valuation derived from the comparative valuation method is considerably sensitive to the valuation of the companies classified as peers and can lead to simplification of the picture of the company.

The target multiple valuation approach is based on the assumption that the value of the company should be equal to pre-specified values of selected price multiples. The advantage of this method is its applicability to each company. From the other hand the target multiple approach is a highly subjective method.

The scenario analysis approach is based on the probability weighted valuation for three sets of assumptions: Bear case (20% probability), base case (60% probability) and bull case (20% probability). The base case is based on the assumptions and estimates which we have included in our financial forecasts and DCF valuation. In the bear/bull case scenarios we have analyzed the valuation sensitivity towards negative/positive changes in various assumptions including market size, market shares, profitability, growth, capex, valuation multiples etc. The advantage of this method is presentation of various scenarios and valuation sensitivity. As an disadvantage we find its complication and sensitivity towards probability weights assumption.

The dividend discount model (DDM) valuation uses predicted dividends that are expected to be paid out by the company and discounts them back to present value. The advantages of the DDM valuation method are its applicability to companies with long-term dividend payout history and the fact that it takes into account real cash streams that are expected to receive by equity-owners. From the other side the DDM valuation method requires a number of assumptions regarding dividend payouts.

The net asset value approach considers the underlying value of the company’s individual assets net of its liabilities. Some of the advantages of the NAV approach are its applicability to asset holding companies and the fact that data required to perform the valuation are usually easily available. From the other hand the valuation derived from net asset value approach does not take into account future changes in sales or income and can understate the value of intangible assets.

The sum of the parts approach values a company by determining what its divisions would be worth if it was broken up and spun off or acquired by another company. The advantage of this method is a possibility to apply different valuation methods to different divisions. As an disadvantage we find scarcity of comparable basis for the respective business lines.

The discounted residual income model valuation is based on discounted excess equity flows the company is able to deliver. The main advantage of this method is that it is based on return on equity adjusted by cost of equity. The important disadvantage is that it is based on the income statement so does not include actual cash flows, but may fluctuate depending on accounting method.

The ROE-P/BV model valuation is based on the regression line with valuation-to-book value (P/BV) depending on the return on equity the company is able to deliver. The main advantage of the method is that it includes the correlation of valuation with profitability. The main disadvantage is that it does not fully take into account earnings dynamics.

Terminology used in the recommendation:

P/E – price-earnings ratio

PEG - P/E to growth ratio

EPS - earnings per share

P/BV – price-book value

BV – book value

EV/EBITDA – enterprise value to EBITDA

EV – enterprise value (market capitalization plus net debt)

EBITDA – earnings before interest, taxes, depreciation, and amortization

EBIT – earnings before interest and tax

NOPAT – net operational profit after taxation

FCF - free cash flows

ROE – return on equity

WACC - weighted average cost of capital

CAGR – cumulative average annual growth

CPI – consumer price index

COE – cost of equity

L-F-L – like for like

Recommendation definitions:

Buy - indicates a stock's total return to exceed more than 1.5x respective cost of equity over the next twelve months.

Accumulate - indicates a stock's total return to exceed more than respective cost of equity over the next twelve months.

Neutral - indicates a stock's total return to be in range of 0% to respective cost of equity over the next twelve months.

Reduce - indicates a stock's total return to be in range of minus respective cost of equity to 0% over the next twelve months.

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