KGHM

Neutral (from Accumulate)

TP: PLN 64

- **Rating downgrade to Neutral from Accumulate with 12M TP up to PLN 64**
- **We expect 2016E net profit of PLN 605m**
- **2016E-2017E adj. EV/EBITDA of 4.8x**

Vestor DOM MAKLERSKI
equity research

8 February 2016

Balanced risks

Since our latest research KGHM share price appreciated by 18% during the global commodity rally and reached our target price, hence we downgrade the stock to Neutral from Accumulate. Although the initial January sell-off proved to be overdone as we expected, the rebound has exhausted near term upside and the risks are more balanced going forward. China's hard landing remains the biggest risk factor for the sector. Furthermore, we're still waiting for KGHM to reveal the amount of asset writedowns which may harm dividend expectations in 2016, as the Sierra Gorda write-off itself may reach USD 700m (PLN 2.8bn). We also point to political risks stemming from new management that may lead to 1) foreign assets disposal (positive in the ST, however would harm LT potential) 2) investment in "non-core" assets (coal mining, utilities). On the positive risks side we point to further assurances from the government regarding potential changes in MET starting in 2017. A 10% decrease in MET burden would add PLN 4.8/share to valuation according to our estimates. Furthermore we note that if the Treasury stuck to a dividend policy on a normalized earnings basis we would expect DPS of 3.5, which implies a firm DY of 5.8%, superior within the peer group. KGHM is trading at our 2016-2017E adj.EV/EBITDA of 4.8xwith P/E of 20.4x and 14.8x, respectively. Based on DCF we increase our 12M TP to PLN 64 from PLN 63, but due to share price appreciation we downgrade the stock to Neutral.

Commodities rally under China's slowdown shadow. Copper rallied by 7.1% from its bottom at USD 4,327/t along with other commodities driven by oil prices and USD depreciation. We believe however, that until the risk of China's hard landing subsidies all commodity rallies will be short-lived, especially as fears of US going into recession emerged after poor December manufacturing data.

Asset writedown leads downside risks. Apart from possible reversal of copper prices we see a write-off of KGHM mining assets as a big threat to 2016 dividend. The Sierra Gorda write-off itself may amount to USD c.700 m (PLN 2.8bn) if KGHM evaluated the project in the same manner as its partner, Sumitomo. Furthermore, there is a lot of uncertainty regarding new management and potential "diversification" requested by the Minister of Treasury, which may indicate KGHM buying coal mining or utilities assets.

MET changes as the upside risk. Since our latest research there were numerous comments from the governing party that the government is working on changes in the MET starting in 2017. In the current macro environment we estimate the MET burden at PLN 1.2bn/annually or PLN 9.7bn (PLN 46/share) valuation-wise. Other upside risks include: 1) 2016 dividend payment from normalized earnings with our estimate of DPS 3.5, which would imply DY of 5.8%. 2) capex cuts including freezing foreign investment projects.

Earnings. With new copper (USD 4650/t vs USD 4500/t) and silver (USD 14.8/troz vs USD 13.8/troz) assumptions we have increased 2016-2017E adj. EBITDA estimates by 9% and 7% to PLN 4.2b and PLN 4.5bn, respectively.

Figure 1. KGHM: Financial forecast and valuation

		2013	2014	2015E	2016E	2017E
Revenues	PLN m	24,110	20,492	19 702	19 248	19 226
EBITDA	PLN m	6,174	4,988	4 597	3 861	4 071
EBITDA+ SG	PLN m	6,174	4,988	4 557	4 200	4 546
Net profit	PLN m	3,033	2,450	1 303	605	833
EPS	PLN	15.2	12.3	6.5	3.0	4.2
DPS*	PLN	9.8	5.0	4.0	1.0	3.0
P/E (x)	x	9.5	11.6	9.5	20.4	14.8
EV/EBITDA**(x)	x	3.9	7.0	4.0	4.8	4.8

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

Company data

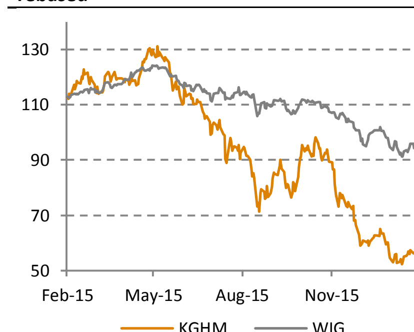
Target Price (PLN)	64
Previous target price (PLN)	63
Share Price (PLN)	62
Upside	5%
Min (52W)	51
Max (52W)	131
No. of shares (m)	200
Market cap (PLN m)	12 324
Net debt 3Q2015 (PLN m)	5 244
EV (PLN m)	17 568
Avg. 3M Turnover (PLN m)	73

Shareholders	%
State Treasury	31.8
Others	68.2

Company description

KGHM is the 10th largest refined copper producer with 571kt output in 2012 (3% of 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 dated 4th November 2015 with the target price 107PLN and one accumulate recommendation dated 12th January 2016 with the target price 63PLN. Vestor may act as a market maker for the shares of KGHM now and in the future.

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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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