Metals&Mining | Poland

Company update

KGHM

Accumulate (from Buy)

TP: PLN 63

- **Rating downgrade to Accumulate from Buy with 12M TP down to PLN 63**
- **We expect 2016E net profit of PLN 327m**
- **2016E-2017P adj. EV/EBITDA of 4.8x and 4.9x**

Vestor DOM MAKLERSKI

equity research

12 January 2016

Turbulent start into 2016

We are significantly cutting our earnings forecast and valuation for KGHM on the back of a) new copper price assumptions - given uncertainty regarding China, we are marking to market copper prices (to USD 4500/t for 2016 from USD 5140/t), b) lower estimates for Sierra Gorda, and 3) we now apply only 50% probability to changes in MET tax starting in 2017. As a result, we are downgrading our 2016 EBITDA and net profit forecasts by 23% and 84% respectively, to PLN 3.5bn and PLN 327m. After the update, KGHM is trading at 2016 EV/EBITDA of 4.8x, with 22% discount to its peers. We admit that our early November upgrade call on KGHM was premature as contrary to our expectations China risks have materialized while MET changes have not. We are cutting our target price to PLN 63 from PLN 107 and downgrade our rating to Accumulate from Buy. While we believe that in the long run the current share price is likely to turn out a good buying opportunity, both global and company-specific risks (likely management change, asset writedowns, no dividend, potential value-destructive investments in state-owned assets) seem particularly difficult to quantify at the moment.

Marking to market copper price assumptions after a 13% fall since early November. Since our last research on Nov 4 until end of 2015 the price of copper has dropped by 8% to USD 4,705/t despite supply cuts made by Freeport McMoran or Glencore. Entering 2016 on the back of weak China industrial production data, copper experienced another 5% drop to USD 4,485/t – the lowest level since May 2009. Nevertheless, we believe that as supply cuts physically arrive, the market will move to a deficit of 127kt expected by ICSG which should support metals prices going forward.

Cutting 2016E earnings estimates. Due to lower copper prices (USD 4,500/t) we expect KGHM reported EBITDA to drop by 23% yoy to PLN 3.5bn in 2016E with EBTIDA adj. for Sierra Gorda contribution at PLN 3.8m. The consolidated bottom line will be additionally affected by Sierra Gorda as we expect net profit to drop 76% yoy to PLN 327m in 2016E.

Confusion about political factors. Following recent comments from Minister of Treasury we now assign 50% probability for the MET deductibility from CIT starting 2017. The Minister also requested the supervisory board to examine foreign projects and consider diversification of KGHM's operations. Having in mind likely changes in management no scenario including KGHM selling its foreign operations and buying domestic state-owned assets can be ruled out. Moreover, KGHM is very likely to announce non-cash asset writedowns, which may lead to limited dividend payment from 2015 earnings.

Valuation. Our new 2016-17E EPS forecast implies P/E of 32.5x and 18.4x, however we believe that due to Sierra Gorda consolidation EV/EBITDA is a more proper multiple for KGHM peers comparison. With 2016-2017E adj. EV/EBITDA multiples at 4.8x and 4.9x, respectively, KGHM is trading with a 22% and 7% discount to its peers.

Figure 1. KGHM: Financial forecast and valuation

		2013	2014	2015E	2016E	2017E
Revenues	PLN m	24,110	20,492	19 702	18 812	18 794
EBITDA	PLN m	6,174	4,988	4 597	3 549	3 793
EBITDA+ SG	PLN m	6,174	4,988	4 557	3 854	4 230
Net profit	PLN m	3,033	2,450	1 369	327	575
EPS	PLN	15.2	12.3	6.8	1.6	2.5
DPS*	PLN	9.8	5.0	4.0	1.0	2.7
P/E (x)	x	9.5	11.6	7.7	32.5	18.4
EV/EBITDA**(x)	x	3.9	7.0	3.6	4.8	4.9

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

Company data

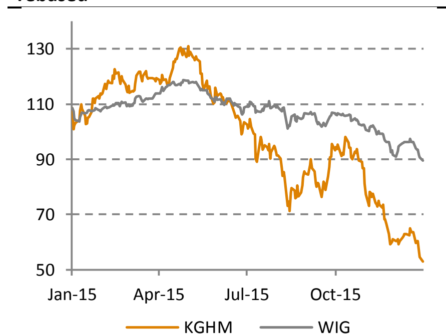
Target Price (PLN)	63
Previous target price (PLN)	107
Share Price (PLN)	53.00
Upside	19%
Min (52W)	51.5
Max (52W)	131.4
No. of shares (m)	200
Market cap (PLN m)	10 600
Net debt 3Q2015 (PLN m)	5 244
EV (PLN m)	15 844
Avg. 3M Turnover (PLN m)	89

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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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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