Oil & Gas | Poland

PGNiG

Sell

TP: PLN4.4

- In the last 2M PGNiG share price has risen 5% despite a respective 22% and 8% drop of gas and crude oil prices.
- We cut our 2016F norm. EBITDA forecast by 7% to PLN5.1bn (down 27% YoY), 11% below consensus.
- PGNiG trades at 2016F EV/EBITDA of 6.2x, 3% premium to peers (vs. historical average discount of 15%).

Vestor DOM MAKLERSKI

equity research

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Downgrade to Sell on demanding valuation

Since our last recommendation from December 16th, PGNiG's share price has risen 5%, largely in line with the WIG index. At the same time TTF gas price and Brent crude have dropped by 22% and 8%, respectively. We are downgrading PGNiG from Reduce to Sell with a new 12M TP of PLN4.4 (down from PLN4.6). We reiterate our view that the outlook for 2016 results is weak, while a significant retroactive payment from Gazprom is unlikely. We cut our 2016F norm. EBITDA forecast by 7% to PLN5.1bn (down 27% YoY), 11% below consensus. Based on our forecasts PGNiG trades at 2016F EV/EBITDA 6.2x, a 3% premium to peers vs. historical discount of 15%. The main upside risks are: potential large one-off dividend or value-accretive upstream acquisitions.

Preliminary 4Q15 results – norm. EBITDA of PLN1.5bn, down 24% YoY. On February 10th, PGNiG published preliminary 4Q results. Reported EBITDA reached PLN0.77bn, down 43% YoY, including: (1) PLN0.5bn impairment in Upstream; (2) PLN0.22bn gas inventory write-off in Trade&Storage; (3) PLN0.11bn negative hedging result – mainly in the T&S segment. We do not perceive the hedging result as a one-off and calculate norm. EBITDA of PLN1.5bn, down 24% YoY. We expect strong results of Distribution and Heat&Power, forecast norm. EBITDA of Upstream to be down 17% YoY, while Trade&Storage result to be down 91% YoY.

Trage&Storage – margin on gas to worsen in 2016F. Taking into account PGNiG's discount scheme launched in 2Q15, we calculate 2016F PGNiG's effective gas sales price of PLN85/MWh, down 22% YoY vs. our estimate of a 16% YoY decline of the weighted average cost of gas (incl. gas from QatarGas). We assume that the retail gas tariff is cut 6% from 2Q16, while the wholesale tariff is liberalized in mid-2016. Even though we assume that in mid-2016 PGNiG reaches and agreement with Gazprom and that the gas component in the Yamal formula increases to 60% (from the current 30%, based on our estimates), we do not expect any material retroactive payment.

2016F norm. EBITDA cut by 7% to PLN 5.1bn, down 27% YoY and 11% below consensus. In our base case scenario, we assume Brent crude price of US$36/bb in 2016F and US$42 in 2017F. Following the recent drop of gas and crude oil prices, we cut our norm. EBITDA forecast for 2016F by 7% to PLN5.1bn (down 27% YoY, 11% below consensus) In 2017F, we expect EBITDA of PLN5bn (down 3% YoY, 15% below consensus).

Valuation. We value PGNiG using a 70/30% combination of a DCF model and peer comparison to E&P and integrated gas companies. Our new 12M target price comes in at PLN4.4, implying 15% downside. Based on our forecasts, PGNiG trades at 2016F and 2017F EV/EBITDA of 6.2x and 6.4x, respectively. It implies a respective 3% and 11% premium to peers (vs. historical average discount of 15%).

PGNiG: Financial forecasts and valuation

	2012	2013	2014	2015F	2016F	2017F
Norm. EBITDA (PLNm)	1 413	6 513	7 521	7 058	5 124	4 979
Norm. Net income (PLNm)	-347	2 648	3 776	3 004	1 908	1 797
EV/EBITDA (x)	27.6	5.5	4.5	4.5	6.2	6.4
PER (x)	n/m	11.6	8.1	10.2	16.1	17.1
Dividend yield (%)	0.0	2.5	2.9	3.8	5.1	3.7

Source: Bloomberg, Vestor DM estimates

Throughout this report we are using prices as of 17.02.2016 unless otherwise stated

Company data

Target Price (PLN)	4.4
Share Price (PLN)	5.2
Upside/downside	-15%
Min (52W)	4.5
Max (52W)	7.0
No. of shares (m)	5,900
Market cap. (PLNm)	30,680
Net debt (15F, PLNm)	1,424
EV (15F, PLNm)	32,111
Avg. 3M Turnover (PLNm)	26.5

Shareholders	%
State Treasury	70.8
Others	29.2

Company description

PGNiG is the largest natural gas producer and distributor in Poland. In 2015 the company produced 4.6bcm of natural gas and 1.4mt of crude oil. The company's proved gas reserves in Poland come in at 82bcm and the company also holds 3 shale gas exploration licenses. PGNiG sells gas to 6.8m end-customers through 125ths km of distribution network. Apart from its Polish operations, PGNiG holds stakes in oil and gas producing fields in Norway with 2P reserves of 81mboe, and in exploration licenses in Libya and Pakistan. In 2012 PGNiG acquired assets of Vattenfall Heat Poland with a total installed capacity of 1GWe and 4.8GWt.

PGNiG vs. WIG 1Y price performance

Source: Bloomberg, Vestor DM

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Over the last twelve months, Vestor issued one neutral recommendation dated 15th May 2015 with target price 6.30PLN and one reduce recommendation dated 16th December 2015 with the target price 4.6PLN. Vestor may act as a market maker for the shares of PGNiG 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.

Sell - indicates a stock's total return to be less than minus respective cost of equity over the next twelve months.

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