

- Estimated voluntary leave program NPV at PLN 330m or PLN 7.4 per share
- We raise our 2015-16 EBITDA estimates up 20% and 31% to PLN 890m and PLN 1,046m
- 2015 P/E of 12.2x and EV/EBITDA of 5.2x
- Key risk tied to domestic coal market and election year

PDO changes track

We are upgrading our rating for PKP Cargo to Neutral from Reduce, mainly on the back of larger than expected positive impact of the Voluntary Leave Program (PDO). We estimate the NPV of the expanded PDO at PLN 7.4 per share with cost savings of PLN 130m in 2015E on EBITDA level. With greater PDO and newly acquired AWT our new 2015E EBITDA and net profit estimates put PKP Cargo EV/EBITDA and P/E multiples at 5.4x and 12.2x, respectively which we consider fair. Although the coal market risks remain still in place, we believe that successful cost cutting, acquisition-related newsflow and 3.4% dividend yield should support the stock. Our new 12 TP of PLN 97 offers 8% upside.

Increasing NPV of the PDO program to PLN 330m or PLN 7.4 per share. With the PDO being expanded to 3,041 employees from 1,300 we have increased the NPV of the project to PLN 330m or PLN 7.4 per share, from PLN 1.8 per share. In addition to positive impact on near-term earnings, we like the relatively smoothless execution of the major cost cutting plan.

AWT: Strategic acquisition at reasonable price, not without risks. We like the acquisition of Czech AWT as a strategic move, in the context of PKPC's international expansion. Valuation, at 5x 2014 EBITDA may appear closer to 6x if the risks to 2015E earnings materialise. As main risks to 2015 results we especially point to lost Chvaletice contracts and the pricing of the new 3y contract with OKD/NWR.

We are rising our 2015E adj. net profit estimate to PLN 330m. Despite lower coal volumes assumptions we have raised our 2015-2016 EBITDA estimates by 20% and 31% to PLN 890m and PLN 1,046m mostly on the back of the PDO and AWT acquisition. Our new 2015E EBITDA is 14% above consensus, which we believe will be revised upwards to incorporate recent newsflow. Moreover we note that 2015E reported bottom line will be supported by PLN 50m lower income tax (PDO effect).

Valuation. On our estimates PKPC is trading at 2015-2016E EV/EBITDA of 5.4x and 4.8x with P/E of 12.2x and 10.6x, respectively, which we find fair given positive outlook for domestic rail freight market after 2016 and short term risks tied to the coal market. We value PKPC using two methods: 1) DCF at PLN 88 per share and 2) comparable multiples at PLN 92 per share. Our 12m target price of PLN 97 per share is 8% above current market price.

Potential catalysts to change our rating. We would be looking for rail freight market development in 2015 under impact of coal sector crisis. Furthermore we would need to see PKPC put stop to continuous market share and freight rates erosion to further lift our rating.

PKP Cargo: Financial summary

		2012	2013	2014E	2015E*	2016E
Sales	PLN m	5 173	4 797	4 224	4 609	5 251
EBITDA	PLN m	767	499	446	890	1 046
Adj. EBITDA	PLN m	767	708	694	890	1 046
Net profit	PLN m	268	74	37	380	382
Adj. net profit	PLN m	268	200	275	330	382
DY	%	n.a.	n.a.	3.7%	3.4%	4.7%
Adj. P/E	X	n.a.	18.6	14.6	12.2	10.6
P/E	X	n.a.	54.4	109.2	10.6	10.6
Adj. EV/EBITDA	X	n.a.	5.2	5.6	5.4	4.8
EV/EBITDA	X	n.a.	7.4	8.7	5.4	4.8

Source: Company data, DII Research, *AWT earnings consolidated since 2H2015

Company data (as of 2015-02-02)

Target Price (PLN)	97
Share Price (PLN)	90
Upside	8%
Min (52W)	70.8
Max (52W)	91.2
No. of shares, diluted (m)	44.8
Market cap (PLN m)	4,031
Net debt (PLN m)	-69
EV (PLN m)	3,962
Avg. 3M turnover (PLN m)	3.4

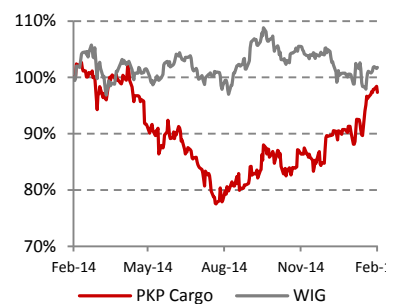
Shareholders

PKP SA	33.0%
ING OFE	10.6%
Morgan Stanley	5.3%
Aviva OFE	5.2%
EBRD	5.1%

Company description

PKP Cargo is the largest Polish and 2nd biggest rail freight operator in the EU with transported volume of 116.7mt and freight turnover of 29.9bn tkm in 2012. Besides rail freight, PKP Cargo provides over 1,000 clients with comprehensive logistic services such as forwarding, siding maintenance and terminal services. In addition to the domestic market, the company is prepared for operation in other rail freight markets such as Germany, Austria, Slovakia, Czech, Belgium and is ready to enter Hungary.

PKP Cargo vs. WIG: Relative performance



Source: Bloomberg

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The date on the first page of this report is the date of preparation and publication of the document.

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In preparing this document DI Investors 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.

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 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.

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.

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

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