Polish refiners

2015: New Golden Age of Refining?

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EQUITY / RESEARCH

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European refiners are currently beneficiaries of two major trends: falling crude oil price and strengthening dollar. However, with the fundamental problems of the sector still in place (overcapacity, diesel oversupply), this will not be a new Golden Age of European refining. Nevertheless, with costs of own oil consumption down significantly, 2015 should be a favorable year for refining stocks. Following a major earnings upgrade, we are increasing our TP for PKN Orlen to PLN58 (from PLN46), reiterating an Accumulate rating. We maintain our Neutral rating for Lotos as we believe the positive impact of strong refining margins will be outweighed by weaker Upstream EBITDA, FX losses and negative LIFO effect. On the back of the recent rights issue, we are lowering our TP for Lotos to PLN27 from PLN33.

PKN Orlen (Accumulate, TP PLN58) – Yet another earnings upgrade. PKN share price has risen 23% over the past 3M, outperforming WIG index by 25ppt driven by refining margin rebound. We have incorporated lower crude oil price and stronger dollar, upgrading our 2015F and 2016F EBITDA forecasts by 16% and 22%, respectively. We now forecast 2015F norm. EBITDA of PLN5bn, up 100% YoY and 12% above consensus. PKN trades at 2015F EV/EBITDA of 5.5x, an 7% discount to European peers and 11% discount to its historical average. We are increasing our TP for PKN Orlen to PLN58 (from PLN46).

Lotos (Neutral, TP PLN27) – Equity increase allows for capex and growth. Following the PLN995m rights issue, we have incorporated in our model the B4/B6 project as well as the DCU in its planned size. We have incorporated lower crude oil price and stronger dollar, cutting our norm. EBITDA forecast by 28% to PLN1.3bn in 2015F, 15% below consensus. We upgrade our EBITDA forecast for 2016F by 1% to PLN1.7bn, 6% below consensus. Lotos trades at 2015F and 2016F EV/EBITDA of 8.7x and 6.3x, 51% and 22% respective premium to peers. The multiples seem demanding, but can be explained by peak of capex in the years 2015-16F for investments which should make a positive EBITDA contribution from 2017F onwards.

	2011	2012	2013	2014F	2015F	2016F
PKN						
Norm. EBITDA (PLNm)	6,242	5,050	2,547	2,522	5,044	5,517
Norm. EBITDA LIFO (PLNm)	3,893	5,225	3,211	4,906	6,694	5,517
Net income (PLNm)	2,363	2,345	176	-5,120	2,101	2,424
EV/norm. EBITDA (x)	5.1	6.5	11.0	11.7	5.5	4.9
PER (x)	11.2	7.4	111.7	n/m	10.5	9.1
Dividend yield	0%	0%	2.9%	2.8%	3.0%	3.2%
Lotos						
Norm. EBITDA (PLNm)	1,956.1	2,197.9	738.5	571.5	1,263.0	1,680.2
Norm. EBITDA LIFO (PLNm)	965.1	2,252.8	1,115.1	1,269.8	1,863.0	1,680.2
Net income (PLNm)	787.0	1,963.3	-23.5	-584.7	223.2	545.8
EV/EBITDA (x)	6.2	7.9	11.4	n/m	8.7	6.3
PER (x)	4.4	1.8	n/m	n/m	21.9	9.0

Source: Company data, DI Investors estimates.

Throughout this report we are using prices as of 12.01.2015 unless otherwise stated.

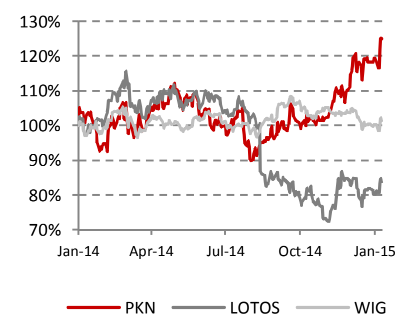
PKN — **Accumulate (maintained)**

Price:	PLN51.45
Target price:	PLN58
Upside:	13%
Market Cap:	PLN22,005m
BBG Ticker:	PKN PW

Lotos — **Neutral (maintained)**

Price:	PLN26
Target price:	PLN27
Upside:	2%
Market Cap:	PLN3,438m
BBG Ticker:	LTS PW

Relative share price performance



Source: Bloomberg, DI Investors

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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 in the model. Small changes in inputs can result in large changes in the value of a company.
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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.
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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
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