

Polish Refiners

New Golden Age of Refining to continue in 2016

27 November 2016

2015 has been a favorable year for the European refining sector so far. Refiners have benefited from lower feedstock costs, exceptionally robust gasoline crack spread and strengthening dollar. We believe 2016 will be another strong year for the sector due to continued low feedstock costs, price competition between sour crude producers, delays of new capacity additions in the Middle East and a number of European refineries postponing maintenance from 2015 to 2016. Following another earnings upgrade, we increase our TP for PKN from PLN58 to PLN83 and upgrade the stock from Accumulate to Buy. We upgrade Lotos from Neutral to Accumulate and increase our TP from PLN27 to PLN34 primarily on the back of Sleipner transaction.

PKN Orlen (Buy, TP PLN83) – Another strong year. PKN share price has risen 61% over the past 12M, but has been down 19% from its peak in August due to a refining macro weakening in October. We perceive the recent share price weakness as a buying opportunity and upgrade our TP from PLN58 to PLN83. Following another upgrade of our macro assumptions, despite the impact of the fire accident in Litvinov, we raise our 2016F norm. EBITDA forecast by 32% to PLN7.1bn (down 25% YoY, but 8% above consensus). We calculate the negative impact of the accident on the group EBITDA of PLN0.6bn in 2015F and PLN0.8bn in 2016F and note that the loss should be covered by insurance policy to a large extent. PKN trades at EV/EBITDA of 5.3x for 2016F, a 6% premium to European peers (vs. historical average premium of 11%) and at the same time below the historical 1YF EV/EBITDA of 6x.

Lotos (Accumulate, TP PLN34) – Value-accretive Sleipner transaction. We upgrade our forecasts and target price taking into account Sleipner transaction and higher-than-expected refining margins. We forecast Sleipner to contribute EBITDA of PLN391m in 2016F and calculate NPV of the acquisition (incl. accelerated tax asset amortization) of PLN3.2/share. We expect Lotos' model refining margin of US\$8.5/bbl (flat YoY) in 2016F and forecast norm. EBITDA of PLN2.3bn in 2016F (up 61% YoY, 35% above consensus). On EV/EBITDA Lotos trades at a premium to peers for 2015F, but at a discount for 2016F. We raise our TP from PLN27 to PLN34 and upgrade the stock from Neutral to Accumulate.

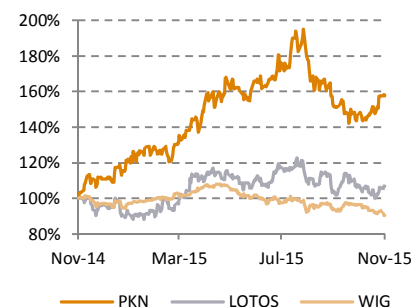
PKN Buy (upgrade from Accumulate)

Price:	PLN68.9
Target price:	PLN83
Upside:	21%
Market Cap:	PLN29,465m
BBG Ticker:	PKN PW

Lotos Accumulate (upgrade from Neutral)

Price:	PLN28.9
Target price:	PLN34
Upside:	18%
Market Cap:	PLN5,337m
BBG Ticker:	LTS PW

Relative share price performance



Source: Bloomberg, Vestor DM

	2012	2013	2014	2015F	2016F	2017F
PKN						
Norm. EBITDA (PLNm)	5 050	2 444	2 599	9 456	7 100	7 044
Norm. EBITDA LIFO (PLNm)	5 225	3 112	4 992	9 847	7 100	7 044
Net income (PLNm)	2 345	176	-5 811	3 549	3 316	3 217
EV/EBITDA (x)	7.9	14.6	14.2	4.1	5.3	5.2
PER (x)	9.9	149.5	n/m	5.9	8.9	9.2
Dividend yield	0%	2.2%	2.1%	2.4%	3.1%	3.3%
Lotos						
Norm. EBITDA (PLNm)	2 198	745	684	1 460	2 349	1 864
Norm. EBITDA LIFO (PLNm)	2 253	1 122	1 326	2 265	2 349	1 864
Net income (PLNm)	1 182	39	-1 466	272	934	659
EV/EBITDA (x)	4.5	12.6	15.6	7.6	4.5	5.1
PER (x)	1.9	-159.4	n/m	47.0	5.7	8.1

Source: Company data, Vestor DM estimates.

Throughout this report we are using prices as of 25.11.2015 unless otherwise stated

Beata Szparaga, CFA
(+48) 22 378 9169
Beata.Szparaga@vestor.pl

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Vestor emphasizes that this document is going to be updated at least once a year.

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

Over the last three months, excluding recommendation contained in this report, Vestor issued 6 Buy recommendation, 4 Accumulate recommendation, 6 Neutral recommendation, 2 Reduce recommendations and 2 Sell recommendations. The proportion of issuers number corresponding to each of the above directions of recommendation, for which Vestor has rendered investment banking services within last 12 months is 70 %. Over the last three months, excluding recommendation contained in this report, Vestor issued 16 reports (recommendations) acting within the Equity Research Partner service for the Issuers without pointing the investment direction or target price.

Over last twelve months, Vestor issued one accumulate recommendation concerning PKN Orlen dated 2015 January, 14 with target price of PLN58 when current price was PLN51.45.

Over last twelve months, Vestor issued one neutral recommendation concerning Lotos dated 2015 January, 14 with target price of PLN26 when current price was PLN 27.

In the case where recommendation refers to several companies, the name "Issuer" will apply to all of them.

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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/neutral/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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