Industrial | Poland

PKP Cargo

Neutral (from Reduce)
TP PLN 36 (prev. PLN 37)

- **We recognize upside factors for 2017e stemming from government policy and higher prices**
- **We increase 2017e EBITDA by 3% to PLN 698m**
- **2017 P/E of 17.3x and EV/EBITDA of 3.4x**

Vestor DOM MAKLERSKI
equity research

28 June 2016

Risks more balanced but not a Buy yet

After another 25% drop in PKP Cargo share price since our last report, we believe the risks are more balanced going forward. Falling market share risk have further materialized with April market share tumbling to 49% and leading to a 10% yoy drop in turnover, which in turn led us to cut our 2016e EBITDA and net profit estimates by 7% and 84% to PLN 572m and PLN 11m, respectively. However, after weak 2016 we see some new upside factors that might support PKP Cargo's results. We point to the government calling for tighter cooperation between state owned companies, which would be supportive for PKP Cargo's turnover and should stop market share erosion. Furthermore, PKPC delivered the first proof in freight rate hikes, although after just a few tenders we believe it's too early to call that a trend reversal. Nevertheless, with 2% higher prices yoy and expected 2.8%yoy growth in turnover we expect 22% yoy growth in EBITDA in 2017e to PLN 698m. On our estimates PKP Cargo is trading at 2016-2017e EV/EBITDA multiples of 4.3x and 3.4x, which seems attractive. At the same time, however we point to very expensive P/E multiples of 130.7x in 2016e and 17.3x in 2017e, which, given high levels of capex, offset the attractiveness of EV/EBITDA multiples. Hence, after a 50% drop since our initial Reduce call and with new positive triggers emerging, we upgrade the stock to Neutral with 12m target price PLN 36 (from previous PLN 37).

Falling market share – waiting for government help. PKPC market share kept eroding in 2016 to only 49% in April partly due to the loss of two coal contracts (PGE and Tauron) to CTL-DB Schenker consortium. However, the new government is calling for tighter cooperation between state owned enterprises at the expense of private rail operators, which may help PKPC stop market share erosion starting in 2017. Most worrisome however is the continuous drop in the most prospective and fastest growing intermodal segment (up 4.8% yoy in 1Q16), where PKP Cargo's market share fell again to 48.8% in 1Q16 from 50.4% in 2015.

Higher prices are becoming a reality. At the beginning of the year the CEO pledged to put an end to the price war in the industry. So far, the company informed about three tenders (2x Enea and PGNiG Termika), where prices were increased by 20-30% yoy. Although it's too early to call it a market trend, we expect 2% yoy growth in PKPC freight rates in 2017e.

Change in estimates. On the back of lower turnover estimates due to lower market share and a further delay of demand for aggregates transportation we cut our 2016e EBITDA and net profit estimates by 7% and 84% to PLN 572m and PLN 11m, respectively. At the same time, with higher prices and expected growth in aggregates transportation, we have increased our 2017e EBITDA estimate by 3% to PLN 698m.

Valuation still demanding. On our estimates PKP Cargo is trading at a 2016-2017e EV/EBITDA of 4.3x and 3.4x, which seems attractive. On the other hand we find PKPC P/E multiples as very demanding not only for 2016e (130.7x), but also for 2017e (17.3x) despite expected 8-fold growth in net profit. We believe that with 1) high capex needs beyond depreciation levels and 2) PLN 0.7bn additional liabilities towards employees, investors should not focus only on EV/EBITDA without taking P/E multiples into consideration.

PKP Cargo: Financial summary

		2014	2015	2016e	2017e	2018e
Sales	PLN m	4 274	4 554	4 597	4 786	4 782
Adj.EBITDA	PLN m	769	637	572	698	717
Adj.net profit	PLN m	267	97	11	86	111
DY	%	3.7%	4.3%	0%	0.4%	2.9%
Adj. P/E	x	13.8	34.3	130.7	17.3	13.4
EV/EBITDA	x	4.6	6.8	4.3	3.4	3.2
Adj. EV/EBITDA	x	6.0	7.9	5.4	4.4	4.2

*Source: Vestor DM research estimates, * net debt adjusted for employee liabilities*

Company data

Target Price (PLN)	36
Previous target price (PLN)	37
Share Price (PLN)	33
Upside	8%
Min (52W)	28.6
Max (52W)	85.8
No. of shares, diluted (m)	44.8
Market cap (PLN m)	1 487
Net debt	983
Adj. net debt (PLN m)	1 700
EV (PLN m)	2 470
Adj. EV (PLN m)	3 039
Avg. 3M turnover (PLN m)	2.6

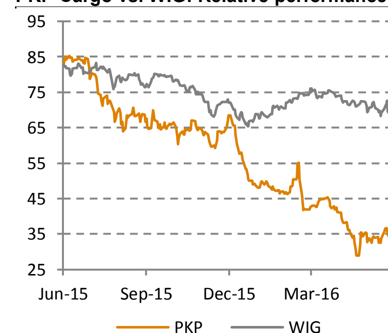
Shareholders

State Treasury	33.0%
ING OFE	10.6%
Morgan Stanley	5.3%
OFE Aviva	5.2%
Others	45.9%

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 Republic, Belgium, and is ready to enter Hungary.

PKP Cargo vs. WIG: Relative performance



Source: Bloomberg

Piotr Nawrocki, CFA
(+48) 22 378 9214
Piotr.Nawrocki@vestor.pl

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Over last twelve months, Vestor issued one reduce recommendation dated April, 21st 2016 with target price PLN37, when the share price was PLN44, one reduce recommendation dated November, 2nd 2015 with target price PLN60 while the share price was PLN 66,4 and one neutral recommendation dated August, 12th 2015 with target price PLN 78 while the current price was PLN74.

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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.

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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.

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.

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

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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.

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