Oil & Gas | Poland
Sector Update

Polish Refiners

Switch from PKN to Lotos

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equity research

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YTD the European refining macro has been mixed. Polish refiners have benefited from the low cost of own usage and strong B/U differential, while the gasoline and diesel crack spreads dropped by 12% and 60% YoY, respectively. With 2016F Brent crude price assumed at US$42/bbl, we raise our forecast of PKN's model refining margin (incl. diff.) from US$7.9/bbl to US$8.7/bbl (down 13% YoY), but cut Lotos' model refining margin from US$8.5/bbl to US$5.5/bbl (down 29% YoY) due to the high weight of diesel. We downgrade PKN from Buy to Neutral with a new TP of PLN76 (down from PLN83) as we believe PKN's valuation is fair given the weakening earnings momentum. Despite the significant cut of refining margin, we maintain our Accumulate rating for Lotos with a new TP of PLN33 (down from PLN34) as we expect strong 1Q16 results and believe the outlook for the remaining part of the year is decent.

PKN Orlen (Neutral, downgrade from Buy TP: PLN76) – Less attractive relative to peers. YTD, PKN's share price has risen 3%, in line with the WIG Index. Following good 1Q16 results, we expect PKN's earnings momentum to weaken in the remaining part of the year due to a high base and planned maintenance. We upgrade our 2016F norm. EBITDA LIFO forecast by 11% to PLN7.9bn (down 22% YoY), but our reported EBITDA forecasts are 5% below and 2% above consensus for 2016 and 2017, respectively. PKN trades at 2016F EV/EBITDA of 5.3x, below the historical average 1YF EV/EBITDA of 5.9x, but at an 18% premium to peers (vs. historical average premium of 6%). We cut our TP from PLN83 to PLN76 mainly on peer group de-rating and downgrade the stock to Neutral.

Lotos (Accumulate, TP: PLN33) – Strong earnings momentum despite demanding environment. We incorporate into our model lower diesel crack spread and Brent crude price, but also lower gas price from PGNiG as well as higher production volume and lower opex in Upstream. We expect Lotos to post strong 1Q16 results. Even though we cut our 2016F norm. EBITDA LIFO forecast by 12% to PLN2.1bn, our EBITDA forecast is in line with consensus for 2016 and 17% above consensus for 2017. Lotos trades at EV/EBITDA of 6.5x for 2016F and 4.5x for 2017F, a respective 29% premium and 4% discount to peers. High multiple for 2016 can be explained by peak of capex for the DCU, which should make a positive EBITDA contribution from 2018F onwards. We reiterate our Accumulate rating with a new TP of PLN33 (down from PLN34).

	2013	2014	2015	2016F	2017F	2018F
PKN						
Norm. EBITDA (PLNm)	2 444	2 599	8 629	6 915	7 204	7 231
Norm. EBITDA LIFO (PLNm)	3 112	4 992	10 039	7 852	7 204	7 231
Net income (PLNm)	176	-5 811	2 843	3 335	3 450	3 416
EV/EBITDA (x)	14.8	14.7	4.5	5.3	5.0	4.8
PER (x)	151.9	n/m	6.3	9.1	8.7	8.8
Dividend yield	2.1%	2.1%	2.4%	2.9%	3.4%	3.9%
Lotos						
Norm. EBITDA (PLNm)	745	684	1 009	1 665	2 197	2 443
Norm. EBITDA LIFO (PLNm)	1 122	1 326	2 165	2 073	2 197	2 443
Net income (PLNm)	39	-1 466	-263	459	847	952
EV/EBITDA (x)	12.6	15.6	11.0	6.5	4.5	3.9
PER (x)	n/m	n/m	n/m	14.8	6.3	5.6

Source: Company data, Vestor DM estimates

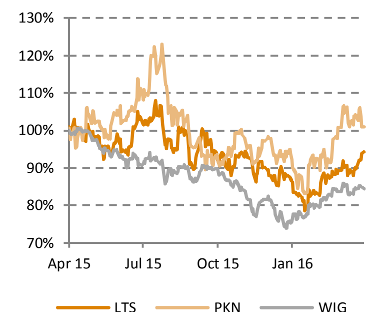
PKN Neutral (downgrade from Buy)

Price:	PLN70.0
Target price:	PLN76.0
Upside:	9%
Market Cap:	PLN29,940m
BBG Ticker:	PKN PW

Lotos Accumulate (maintained)

Price:	PLN28.9
Target price:	PLN33.0
Upside:	14%
Market Cap:	PLN5,350m
BBG Ticker:	LTS PW

Relative share price performance



Source: Bloomberg, Vestor DM

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PKN Orlen - Over last twelve months, Vestor issued one buy recommendation concerning PKN Orlen dated 27th November 2015 with target price of 83PLN when current price was 68.9PLN.

Lotos - Over last twelve months, Vestor issued one accumulate recommendation concerning Lotos dated 27th November 2015 with target price of 34PLN when current price was 28.9PLN.

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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.

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