

- We cut our forecasts mainly due to higher crude price.
- We think the risk of PKN taking part in the nuclear PP project is priced in, while we see positive catalysts: possible correction in crude price, merger with Lotos and strategy announcement.
- PKN trades at EV/EBITDA of 4.7x for 2018F (vs. historical average 5.8x), a double-digit discount to European refiners vs. historical 9% premium.

Political risk priced in, positive catalysts not

YTD PKN's share price has dropped 21%, underperforming the WIG index by 10 ppt due to weak earnings momentum and political risks. While earnings momentum is unlikely to turn positive in the short-term, we upgrade the stock from Neutral to Buy with a new ex-dividend TP of PLN104 (down from PLN117). We believe the risk of PKN taking part in the nuclear power plant project is already priced in, while we see some positive catalysts for the stock: possible correction in crude oil price, execution of merger with Lotos and strategy announcement, which may be comforting for the market. PKN trades at EV/EBITDA of 4.7x for 2018F and 4.8x for 2019F, at a respective 24% and 18% discount to peers vs. historical average 9% premium and vs. historical 1YF EV/EBITDA of 5.8x.

Forecasts cut due to higher crude price. We expect PKN to post weak 2Q18 results on Friday and forecast 2Q norm. EBITDA LIFO of PLN2bn, down 29% YoY. With the Brent crude price now assumed at US\$73/bbl (vs. US\$65/bbl previously) in 2018F and US\$72/bbl in 2019F, we expect PKN model refining margin (incl. differential) of US\$6.2/bbl in 2018F (down 20% YoY) and US\$6.4/bbl in 2019F. As a result, we cut our norm. EBITDA LIFO estimate by 6% to PLN8bn in 2018F (down 18% YoY). In 2019F, we expect norm. EBITDA LIFO of PLN8.3bn, up 3% YoY.

Strategy publication to focus on the petchem segment. In Autumn, PKN is to present an update of the company's strategy, which is likely to focus on development of the petchem segment. The company plans capex for the petrochemical segment development program at PLN8.3bn by 2023 and estimates EBITDA increase of PLN1.5bn/year. The company has not yet revealed enough data to include the 3 planned investments in our forecasts, but at the first glance we see it as a step in the right direction.

Acquisition of Lotos – due diligence in progress. In the coming weeks, we expect PKN to complete the due diligence of Lotos, sign an agreement with the ST to buy 33% stake at a price equal 6M volume-weighted average (PLN57) and file for antimonopoly consent. Taking into account the uncertainty regarding the structure of the merger, EC's approval and upcoming local elections we think it is too early to incorporate the merger into our model or estimate potential synergies, which are an upside risk to our forecasts.

High discount to peers, political risk priced in. Based on our forecasts, PKN trades at EV/EBITDA of 4.7x for 2018F and 4.8x for 2019F, at a respective 25% and 18% discount to peers (vs. historical average 9% premium) and discount to the historical 5-year average 1YF EV/EBITDA of 5.8x. We value PKN using a 50%/25%/25% combination of: (1) target EV/EBITDA multiple; (2) DCF model; and (3) peer comparison to European refiners. We include the nuclear power plant project in our valuation (negative NPV of PLN10/share).

PKN: Financial forecasts and valuation

| | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|--------------------------|--------|-------|--------|-------|-------|-------|
| Norm. EBITDA (PLNm) | 8 623 | 8 038 | 10 501 | 8 689 | 8 256 | 8 450 |
| Norm. EBITDA LIFO (PLNm) | 10 033 | 7 953 | 9 702 | 7 995 | 8 256 | 8 450 |
| Net income (PLNm) | 2 837 | 5 261 | 6 655 | 4 690 | 4 554 | 4 700 |
| EV/EBITDA (x) | 5.2 | 5.2 | 3.8 | 4.7 | 4.8 | 4.5 |
| PER (x) | 7.5 | 9.1 | 5.6 | 7.8 | 7.9 | 7.6 |
| Dividend yield | 2.0% | 2.4% | 3.6% | 3.6% | 3.6% | 4.2% |

Source: Bloomberg, Vestor DM estimates

Company data

| | |
|-------------------------|--------|
| Target Price (PLN) | 104.0 |
| Share Price (PLN) | 83.9 |
| Upside | 24% |
| Previous Target Price | 117.0 |
| Min (52W) | 80.2 |
| Max (52W) | 134.5 |
| No. of shares (m) | 427.7 |
| Market cap. (PLNm) | 35 876 |
| Net debt (18F, PLNm) | 5 154 |
| EV (17F, PLNm) | 41 030 |
| Avg. 3M Turnover (PLNm) | 56.5 |

Shareholders

| | % |
|----------------|------|
| State Treasury | 27.5 |
| NN OFE | 7.0 |
| Aviva OFE | 6.6 |
| PERN | 4.9 |
| Others | 54.0 |

Company description

PKN Orlen is a leading refining and petrochemical company operating in the CEE. PKN operates 7 refineries, of which 3 are located in Poland (Plock, Trzebinia and Jedicze), another 3 in the Czech Republic (Litvinov, Kralupy and Pardubice) and one in Lithuania (Mazeikiu). Total throughput capacity of PKN comes in at 35.2mt. The company's petrochemical assets are fully integrated with refining and have a capacity of 6.2mt. PKN's retail network comprises 2.8k fuel stations in Poland, Germany, the Czech Republic and Lithuania. Since 2013 the company has been developing its Upstream portfolio and currently is involved in projects in Poland and Canada with total 2P reserves of 152mboe.

PKN vs. WIG 1Y price performance



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ii. supervising their own transactions made by individuals, periodic inspection and assessment of the effectiveness of implemented by Vestor control systems and procedures; conducting the legally required registers and records, primarily registry conflicts of interest associated with a significant risk of damage to client interests;

d) Refusal of action: the right to refuse the Vestor activity to the client, if given the commitment to specific activity on behalf of another client Vestor cannot effectively manage potential conflicts of interest, or prevent this regulatory restrictions or internal regulations;

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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 valuation (including ROE-p/BV model),
- 3) Target multiple,
- 4) Scenario analysis,
- 5) Dividend discount model (DDM),
- 6) net asset value (NAV),
- 7) Sum of the parts,
- 8) Discounted residual income model (DRIM),
- 9) Risk-adjusted net present value (rNPV).

The discounted cash flows valuation method (DCF) is based on discounted expected future cash flows. The method includes all cash flows the issuer is expected to generate in a given period and the cost of money over time. However, the DCF valuation method requires a number of assumptions and is very sensitive to changes in parameters used in the model. Small changes in assumptions may result in material changes in the valuation.

The comparative valuation method is based on the rule of "one price". The advantages of the method include 1) a small number of parameters to be estimated, 2) the fact that there is a relatively large number of indicators for companies being compared, 3) The method is well-known among investors, 4) valuation is based on current market conditions. On the other hand, a comparative valuation is strongly sensitive to the valuation of the companies classified as peers and may lead to a simplified picture of the company valued.

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 simplicity and applicability to almost all of the companies. The target multiple approach is a highly subjective method, though.

The scenario analysis approach is based on the probability weighted valuation for three sets of assumptions: Bear case, base case and bull case with a different probability assigned. The base case is based on the assumptions included in financial forecasts and DCF valuation. The bear/bull case scenarios present a 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. A complexity and sensitivity to probability weights assumption may be found as disadvantages.

The dividend discount model (DDM) valuation is based on discounted future dividends that are expected to be paid out by the company over a period of time. The DDM model includes real cash streams that are expected to be received by shareholders and may be applied to companies with long-term dividend payout history. However, the DDM valuation method requires a number of assumptions.

The net asset value (NAV) approach considers the underlying value of the company's individual assets net of its liabilities. Among the advantages of the NAV approach are its applicability to asset holding companies and the fact that data required are usually easy to reach. On the other hand the NAV approach does not take into account future changes in revenues or income and can underestimate the value of intangible assets.

The sum of the parts approach values a company on the back of valuations of its separate divisions. The method is applicable to companies with very different business profiles, but requires identification of peers for business divisions comparison, what may be difficult to achieve.

The discounted residual income model includes equity at the end of a given financial year, excess equity (return on equity over cost of equity) the company is expected to generate in the estimation period and a discounted residual value post-estimation period. On one hand, the method includes profitability of the company compared to a cost of equity, but on the other hand it is strongly dependent on a number of parameters and assumptions.

The risk-adjusted net present value (rNPV) is a method used to forecast future cash flows in high-risk projects. In biotechnology, rNPV method involves forecasting future cash flows and applying probability rates of different phases of drug development. The main advantage of this method is the fact that it takes into account probability of success. The disadvantage of this method is the large number of assumptions and the high level of computational complexity.

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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|---------|------------------|---------------------|---------------------------|--------|--|----------------|--------------|
| 43/2017 | PKO BP | 2017-07-24 | Michał Fidelus | 34.0 | 35.8 | Reduce | 12M |
| 44/2017 | Pekao | 2017-07-24 | Michał Fidelus | 140.0 | 128.0 | Accumulate | 12M |
| 45/2017 | BZ WBK | 2017-07-24 | Michał Fidelus | 349.0 | 362.5 | Reduce | 12M |
| 46/2017 | mBank | 2017-07-24 | Michał Fidelus | 380.0 | 460.0 | Sell | 12M |
| 47/2017 | ING BSK | 2017-07-24 | Michał Fidelus | 191.0 | 189.0 | Neutral | 12M |
| 48/2017 | Handlowy | 2017-07-24 | Michał Fidelus | 71.0 | 68.1 | Neutral | 12M |
| 49/2017 | Millennium | 2017-07-24 | Michał Fidelus | 7.1 | 7.5 | Reduce | 12M |
| 50/2017 | Alior | 2017-07-24 | Michał Fidelus | 68.0 | 60.5 | Accumulate | 12M |
| 51/2017 | Getin Noble Bank | 2017-07-24 | Michał Fidelus | 1.58 | 1.45 | Neutral | 12M |
| 52/2017 | Grupa Azoty | 2017-07-28 | Katarzyna Włodarczyk | 75.0 | 67.6 | Accumulate | 12M |
| 53/2017 | JSW | 2017-08-09 | Marcin Stebakow | 102.0 | 90.5 | Buy | 12M |
| 54/2017 | Ciech | 2017-08-10 | Katarzyna Włodarczyk | 68.0 | 62.5 | Neutral | 12M |
| 55/2017 | Lotos | 2017-08-21 | Beata Szparaga-Waśniewska | 56.0 | 51.0 | Neutral | 12M |
| 56/2017 | Getback | 2017-08-25 | Michał Fidelus | 26.6 | 21.8 | Accumulate | 12M |
| 57/2017 | KGHM | 2017-08-28 | Marcin Stebakow | 153.0 | 126.0 | Buy | 12M |
| 58/2017 | Wawel | 2017-08-30 | Marcin Stebakow | 1153 | 990 | Buy | 12M |
| 59/2017 | Mercator Medical | 2017-09-07 | Aleksandra Jakubowska | 23.1 | 18.0 | Not rated | 12M |
| 60/2017 | Kruk | 2017-09-14 | Michał Fidelus | 340.0 | 311.0 | Accumulate | 12M |
| 61/2017 | Bogdanka | 2017-09-21 | Marcin Stebakow | 95.0 | 78.0 | Buy | 12M |
| 62/2017 | JSW | 2017-09-28 | Marcin Stebakow | 107 | 93 | Buy | 12M |
| 63/2017 | MZN Property | 2017-10-04 | Aleksandra Jakubowska | 2.0 | 1.45 | Not rated | 12M |
| 64/2017 | Warimpex | 2017-10-11 | Marek Szymański | 7.3 | 6.73 | Not rated | 12M |
| 65/2017 | ATC Cargo | 2017-10-13 | Marcin Stebakow | 3.0 | 2.0 | Not rated | 12M |
| 66/2017 | LPP | 2017-10-19 | Marek Szymański | 6962.0 | 7960.0 | Sell | 12M |
| 67/2017 | CCC | 2017-10-19 | Marek Szymański | 322.0 | 265.3 | Buy | 12M |
| 68/2017 | PKO BP | 2017-10-24 | Michał Fidelus | 35.0 | 36.7 | Reduce | 12M |
| 69/2017 | Pekao | 2017-10-24 | Michał Fidelus | 139 | 125.2 | Accumulate | 12M |
| 70/2017 | BZ WBK | 2017-10-24 | Michał Fidelus | 370 | 356 | Neutral | 12M |
| 71/2017 | mBank | 2017-10-24 | Michał Fidelus | 393 | 452.5 | Reduce | 12M |
| 72/2017 | ING BSK | 2017-10-24 | Michał Fidelus | 193 | 191.2 | Neutral | 12M |
| 73/2017 | Handlowy | 2017-10-24 | Michał Fidelus | 75.0 | 70.0 | Neutral | 12M |
| 74/2017 | Millennium | 2017-10-24 | Michał Fidelus | 7.7 | 7.55 | Neutral | 12M |
| 75/2017 | Alior Bank | 2017-10-24 | Michał Fidelus | 80.0 | 70.2 | Buy | 12M |
| 76/2017 | Getin Noble | 2017-10-24 | Michał Fidelus | 1.40 | 1.53 | Reduce | 12M |
| 77/2017 | Marvipol | 2017-10-24 | Marek Szymański | 19.0 | 13 | Not rated | 12M |
| 78/2017 | KGHM | 2017-11-23 | Marcin Stebakow | 134 | 114.25 | Buy | 12M |
| 79/2017 | JSW | 2017-11-29 | Marcin Stebakow | 86.8 | 90.2 | Reduce | 12M |
| 80/2017 | Vigo System | 2017-12-05 | Beata Szparaga-Waśniewska | 455 | 305 | Not rated | 12M |
| 81/2017 | LW Bogdanka | 2017-12-07 | Marcin Stebakow | 75 | 95 | Accumulate | 12M |
| 82/2017 | Śnieżka | 2017-12-08 | Aleksandra Jakubowska | 63 | 69 | Not rated | 12M |
| 83/2017 | Dom Development | 2017-12-14 | Marek Szymański | 90 | 83.4 | Accumulate | 12M |
| 84/2017 | Atal | 2017-12-14 | Marek Szymański | 43 | 41.0 | Neutral | 12M |
| 85/2017 | LC Corp | 2017-12-14 | Marek Szymański | 3.3 | 2.7 | Buy | 12M |
| 86/2017 | Robyg | 2017-12-14 | Marek Szymański | 4.1 | 3.5 | Accumulate | 12M |
| 87/2017 | Lokum Deweloper | 2017-12-14 | Marek Szymański | 23 | 16.55 | Buy | 12M |
| 88/2017 | Archicom | 2017-12-14 | Marek Szymański | 23 | 15.39 | Not rated | 12M |
| 1/2018 | PKO BP | 2018-01-08 | Michał Fidelus | 45 | 44.3 | Neutral | 12M |
| 2/2018 | Pekao | 2018-01-08 | Michał Fidelus | 152 | 134.3 | Buy | 12M |
| 3/2018 | BZ WBK | 2018-01-08 | Michał Fidelus | 442 | 408.4 | Accumulate | 12M |
| 4/2018 | mBank | 2018-01-08 | Michał Fidelus | 443 | 496 | Sell | 12M |
| 5/2018 | ING BSK | 2018-01-08 | Michał Fidelus | 222 | 215 | Neutral | 12M |
| 6/2018 | Handlowy | 2018-01-08 | Michał Fidelus | 86 | 83 | Neutral | 12M |
| 7/2018 | Millenium | 2018-01-08 | Michał Fidelus | 8.9 | 9.4 | Reduce | 12M |
| 8/2018 | Alior | 2018-01-08 | Michał Fidelus | 87 | 78 | Accumulate | 12M |
| 9/2018 | Getin Noble Bank | 2018-01-08 | Michał Fidelus | 1.55 | 1.71 | Reduce | 12M |
| 10/2018 | PKN | 2018-01-09 | Beata Szparaga-Waśniewska | 117 | 106.7 | Neutral | 12M |
| 11/2018 | Lotos | 2018-01-09 | Beata Szparaga-Waśniewska | 54 | 57.4 | Reduce | 12M |
| 12/2018 | PKP Cargo | 2018-02-14 | Marcin Stebakow | 68 | 58.8 | Buy | 12M |
| 13/2018 | BZ WBK | 2018-02-21 | Michał Fidelus | 436 | 385.8 | Buy | 12M |
| 14/2018 | Wielton | 2018-02-23 | Marcin Górnik | 15.3 | 12.36 | Buy | 12M |

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|---------|----------------------------|------------|---------------------------|--------|--------|------------|-----|
| 15/2018 | Selvita | 2018-03-20 | Beata Szparaga-Waśniewska | 85 | 59 | Not rated | 12M |
| 16/2018 | JSW | 2018-03-22 | Marcin Stebakow | 99 | 95.3 | Neutral | 12M |
| 17/2018 | Marvipol Development | 2018-03-26 | Marek Szymański | 8.9 | 8.7 | Not rated | 12M |
| 18/2018 | Kruk | 2018-03-28 | Michał Fidelus | 286 | 208 | Buy | 12M |
| 19/2018 | British Automotive Holding | 2018-03-28 | Marek Szymański | 10.5 | 8.3 | Not rated | 12M |
| 20/2018 | Aplisens | 2018-04-04 | Michał Wojciechowski | 15.1 | 12.9 | Buy | 12M |
| 21/2018 | Wielton | 2018-04-05 | Marcin Górnik | 16.0 | 13.7 | Buy | 12M |
| 22/2018 | KGHM | 2018-04-16 | Marcin Stebakow | 110.0 | 92.0 | Buy | 12M |
| 23/2018 | LPP | 2018-04-18 | Marek Szymański | 9000 | 8965 | Neutral | 12M |
| 24/2018 | CCC | 2018-04-18 | Marek Szymański | 310 | 272 | Buy | 12M |
| 25/2018 | mBank | 2018-04-19 | Michał Fidelus | 441 | 439 | Neutral | 12M |
| 26/2018 | AC | 2018-04-23 | Marcin Górnik | 38.5 | 40.8 | Reduce | 12M |
| 27/2018 | MZN Property | 2018-05-08 | Aleksandra Jakubowska | 2.2 | 1.9 | Not Rated | 12M |
| 28/2018 | Pekao | 2018-05-16 | Michał Fidelus | 148 | 118.7 | Buy | 12M |
| 29/2018 | Archicom | 2018-05-24 | Marek Szymański | 23.0 | 15.9 | Not Rated | 12M |
| 30/2018 | PKO BP | 2018-05-25 | Michał Fidelus | 42.0 | 38.9 | Neutral | 12M |
| 31/2018 | Warimpex | 2018-05-28 | Marek Szymański | 8.3 | 6.0 | Brak | 12M |
| 32/2018 | Handlowy | 2018-06-20 | Michał Fidelus | 81.0 | 67.0 | Buy | 12M |
| 33/2018 | Dom Development | 2018-06-25 | Marek Szymański | 90.0 | 86.0 | Neutral | 12M |
| 34/2018 | Atal | 2018-06-25 | Marek Szymański | 43.0 | 37.0 | Accumulate | 12M |
| 35/2018 | LC Corp | 2018-06-25 | Marek Szymański | 3.0 | 2.4 | Buy | 12M |
| 36/2018 | Lokum Deweloper | 2018-06-25 | Marek Szymański | 25.0 | 18.8 | Buy | 12M |
| 37/2018 | CCC | 2018-07-16 | Marek Szymański | 280.0 | 204.0 | Buy | 12M |
| 38/2018 | LPP | 2018-07-16 | Marek Szymański | 9200.0 | 9105.0 | Neutral | 12M |