Metals&Mining | Poland

Company update

KGHM

Reduce (from Neutral)

TP: PLN 68

- Rating downgrade to Reduce from Neutral with 12M TP up to PLN 68
- We expect 2016E net profit of PLN 980m
- 2016E-2017E EV/EBITDA of 4.6x and 4.7x

Vestor DOM MAKLERSKI

equity research

9 March 2016

Not enough stimulus for further rally

Since our latest research KGHM share price appreciated by 16% during the global commodity rally. Throughout last two weeks copper soared 8% to USD 5008/t ahead of Chinese National People Congress in anticipation of more fiscal stimulus from the Chinese government and due to short covering. Although China's hard landing seems less probable in the short-term, we believe that its government didn't provide enough arguments to fuel another copper rally, especially as short covering seems to be over and market is more balanced. As the risk to 2016 dividend materialized with PLN 5.1bn write-off we still point to political risks that may lead to investment in "non-core" assets (coal mining, utilities) in Poland. On the positive risks side we point to further assurances from the government regarding potential changes in MET starting in 2017 and potential cut in capex spending in new strategy. With new copper price at USD 4,950/t (prev. USD 4,650) and silver at USD 15.5/troz (prev. USD 14.8/troz) we have increased our 2016-2017 EBITDA estimates by 5% and 6% respectively to PLN 4.4bn and PLN 4.6bn. KGHM is trading at our 2016-2017E EV/EBITDA of 4.6x and 4.7x with P/E of 14.9x and 11.7x, respectively. Based on DCF we increase our 12M TP to PLN 68 from PLN 64, but due to share price appreciation we downgrade the stock to Reduce from Neutral.

Chinese hard-lending less likely but announced stimulus not sufficient to fuel another rally. Since Feb 9th copper prices appreciated by 11% to USD 5,008/t. in anticipation of Chinese fiscal stimulus to be announced on National People Congress. The announced 2016 growth target range 6.5-7% came in line with consensus but targeted fiscal deficit level ended at the lower bound of 3-4% market expectations. Although we recognize fiscal and monetary stimulus bringing some stability to demand for copper, we also feel it's not enough to fuel another rally in metals prices, especially as fixed assets investment growth target of 10% for 2016p is much lower than 2014-15 targets of 17.5% and 15%, respectively. Furthermore, China manufacturing PMI February reading of 49.0 has not provided any arguments for a Chinese economy turnaround yet.

Dividend risk materialized due to asset write-downs. KGHM increased the amount of asset impairment at the parent unit level to PLN 4.9bn from PLN 1.1bn before. With no changes to dividend policy this implies no dividend from 2015 results given the expected PLN 2.7bn loss. We also note that according to February's agreement with labour unions, one-off costs will not affect employees annual bonus formula – est. cost PLN 190m in 2016p.

4Q preview. On the back of seasonally strong sales volumes we expect 4Q15 parent unit EBITDA of PLN 970m (+8%QoQ) with consolidated EBITDA of PLN 1,061m(flat QoQ). Bottom line will be burdened with PLN 5.1bn asset write-downs and PLN 1.7bn negative contribution from Sierra Gorda. All in all, we expect net loss of PLN 6,283m with norm. net profit of PLN 184m. KGHM is set to report 4Q figures on March 17th.

Earnings. With new copper (USD 4950/t vs USD 4650/t) and silver (USD 15.5/troz vs USD 14.8/troz) assumptions we have increased 2016-2017E adj. EBITDA (incl. Sierra Gorda) estimates by 12% and 16% to PLN 4.7b and PLN 5.1bn, respectively.

Figure 1. KGHM: Financial forecast and valuation

		2013	2014	2015E	2016E	2017E
Revenues	PLN m	24,110	20,492	19 936	20 086	20 180
EBITDA	PLN m	6,174	4,988	4 788	4 400	4 632
EBITDA+ SG	PLN m	6,174	4,988	4 748	4 684	5 073
Net profit	PLN m	3,033	2,450	-5 058	980	1249
EPS	PLN	15.2	12.3	-25.3	4.9	6.2
DPS*	PLN	9.8	5.0	4.0	0.0	3.5
P/E (x)	x	9.5	11.6	n.a.	14.9	11.7
EV/EBITDA(x)	x	3.9	7.0	4.0	4.6	4.7

*Source: Company data, Vestor DM estimates,*paid in a given year,*

Company data

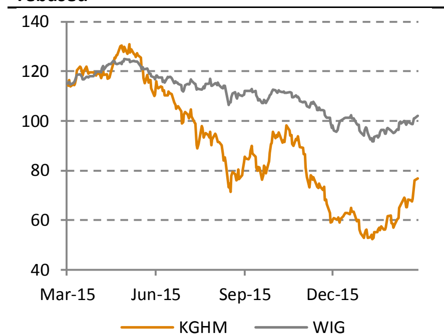
Target Price (PLN)	68
Previous target price (PLN)	64
Share Price (PLN)	73
Upside	-7%
Min (52W)	51.0
Max (52W)	131.4
No. of shares (m)	200
Market cap (PLN m)	14 600
Net debt 3Q2015 (PLN m)	5 244
EV (PLN m)	19 844
Avg. 3M Turnover (PLN m)	77.5

Shareholders	%
State Treasury	31.8
Others	68.2

Company description

KGHM is the 10th largest refined copper producer with 571kt output in 2012 (3% of global supply). It is also the world's biggest silver producer. The core Polish underground mines extract c.420kt, while in 2012 KGHM diversified to the Americas, buying Quadra FNX. It currently runs the 55% owned greenfield open pit Sierra Gorda project in Chile (230kt target output, 20y LOM, feasible as of 2014). Polish assets are in the 3rd quartile of the global cost curve with Sierra Gorda assumed to fit into the 1st. KGHM aims to expand its own production to 700kt.

KGHM vs WIG 1Yr relative price performance rebased



Source: Bloomberg

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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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