

- 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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 - i. the internal reporting system is to provide immediate information to the persons responsible for overseeing compliance with the principles set out in the Regulations for the event of a conflict of interest or risk of its origin;

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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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 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.

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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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

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