

Tuesday, December 05, 2017 | special comment

## PGNiG – Overplayed Impact of Oil On Trading Profits

Rating: buy | target price: PLN 7.73 PLN | current price: PLN 5.86

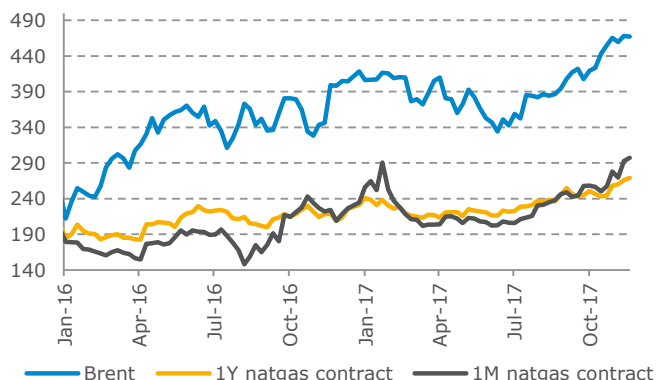
**PGN PW; PGN.WA | Oil & Gas, Poland**

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PGNiG shares have plummeted nearly 15% in the quarter to date, with sentiment dampened by expectations that rising prices of oil will hurt the gas company's trading profits in 2018. What the market is overlooking, however, is the fact it is not the price tag itself that shapes these profits, but, rather, it is its relationship to the prices of natural gas, serving as a measure of the extent to which the higher costs can be passed onto end consumers. In the diagrams below, we tried to demonstrate that, by the end of September 2017, European gas contracts had fully priced the 10% ytd increase in the price of Brent crude, and that the margins that PGNiG earns on gas purchased from Russia's Gazprom (with the pricing indexed to POLPX forward contracts) have been holding at steady levels. The Company's LNG supply deal with Qatargas could put a strain on the future trading profits (see chart at bottom left), but the impact is bound to be small given the low volumes (any change in margin by PLN 10/MWh is equivalent to ca. PLN 0.2bn of EBITDA). Investors should also keep in mind the deregulation of Polish commercial natgas sales, in effect since October 2017, which allows PGNiG to

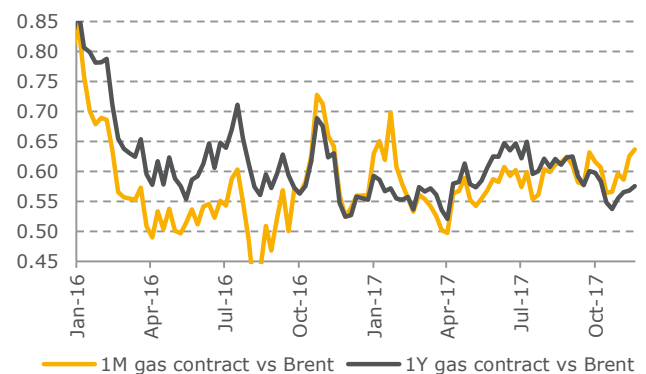
flexibly adjust the prices charged from commercial end users, who represent over 75% of the total sales volumes, to market reality. In our view, the free market pricing for commercial gas sales will more than offset the potential negative effects of the remaining tariff regime for household prices (with the costs based on POLPX quotes up by an estimated PLN 8/MWh, and any PLN 1/MWh shift not reflected in the tariff taking away about PLN 50m from PGNiG's margin), with an additional boost to the tune of PLN 6/MWh provided by cross-border spread (geographic premium), set to add PLN 0.8bn to revenues. Further, keep in mind that rising gas prices drive PGNiG's profits from E&P activity, with the additional revenue at the current price level exceeding PLN 0.7bn. Summing up, we still very much recommend PGN as a buy, and with the stock trading at 4.5x 2017E EV/EBITDA and 3.9x 2018E EV/EBITDA on our estimates, it offers a substantial discount to upstream peers (5.3x) and an even bigger discount relative to comparable utilities (trading, heat, and distribution are expected to generate 40% of the annual EBITDA in the years 2017-2019).

### European natgas prices vs. Brent crude (\$/toe)

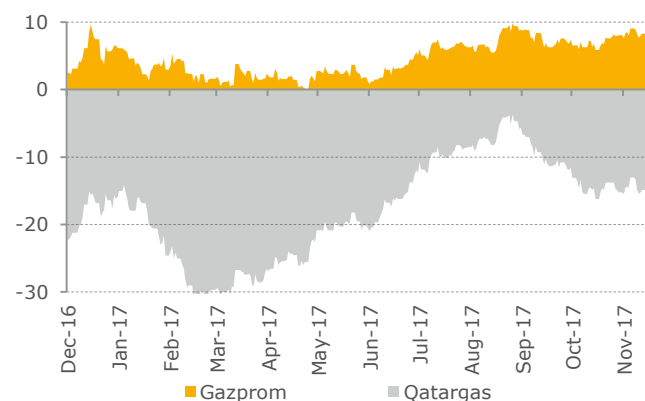


Source: Bloomberg, Dom Maklerski mBanku

### EU natgas vs. Brent prices



### PGNiG margins on Qatar & Russia gas (PLN/MWh)\*



### Natgas prices in Germany and Poland (PLN/MWh)



\*Theoretical margins on sales of gas supplied under each contract at the 1Y fwd price quoted on the POLPX exchange  
Source: Bloomberg, Dom Maklerski mBanku

**List of abbreviations and ratios contained in the report.**

**EV** – net debt + market value (EV – economic value)  
**EBIT** – Earnings Before Interest and Taxes  
**EBITDA** – EBIT + Depreciation and Amortisation  
**PBA** – Profit on Banking Activity  
**P/CE** – price to earnings with amortisation  
**MC/S** – market capitalisation to sales  
**EBIT/EV** – operating profit to economic value  
**P/E** (Price/Earnings) – price divided by annual net profit per share  
**ROE** – (Return on Equity) – annual net profit divided by average equity  
**P/BV** – (Price/Book Value) – price divided by book value per share  
**Net debt** – credits + debt papers + interest bearing loans – cash and cash equivalents  
**EBITDA margin** – EBITDA/Sales

**OVERWEIGHT (OW)** – a rating which indicates that we expect a stock to outperform the broad market  
**NEUTRAL (N)** – a rating which indicates that we expect the stock to perform in line with the broad market  
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**HOLD** – we expect that the rate of return from an investment will range from -5% to +5%  
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**Relative** – based on a comparison of valuation multipliers of companies from a given sector; simple in construction, reflects the current state of the market better than DCF; weak points include substantial variability (fluctuations together with market indices) as well as difficulty in the selection of the group of comparable companies.

**Economic profits** – discounting of future economic profits; the weak point is high sensitivity to changes in the assumptions made in the valuation model.

**Discounted Dividends (DDM)** – discounting of future dividends; the weak point is high sensitivity to changes in the assumptions as to future dividends made in the valuation model.

**NAV** – valuation based on equity value, one of the most frequently used method in case of developing companies; the weak point of the method is that it does not factor in future changes in revenue/profits of a company.

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