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PKN Orlen & Lotos: Merger Rumors Revisited

PKN Orlen (PKN PW) | Rating: sell | target price: PLN 82.84 | current price: PLN 95.04

Lotos (LTS PW) | Rating: reduce | target price: PLN 52.67 | current price: PLN 57.30

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The PKN-Lotos merger rumors that have flared up again over the recent days have so far not had much bearing on either stock as the market waits for any concrete developments. Nevertheless, we thought it would be worth exploring the possible scenarios and outcomes of a merger between Poland's two largest state-controlled refiners. It is hard to say which type of transaction would be best for whose minority shareholders, but in terms of voting powers it is the minorities of PKN that can probably expect to be offered some form of an incentive, in the form of a favorable swap ratio, to approve a potential stock-for-stock merger. This is where we should point out the 18% deviation of LTS from the indicative 6-month exchange ratio for the two stocks. When it comes to the potential synergies, the many different areas which stand to benefit from the combination of the two businesses include general expenses (PLN ~0.1bn), selling expenses (PLN ~0.3bn), and profit margins (~PLN 0.2bn), though the actual gains will depend on whether the two organizations are combined into one or left to function as two independent publicly-traded units. In terms of operating costs, any downsizing plans would most likely meet with strong labor pushback which would require skilful handling. Assuming our synergy estimates are accurate, at 6.0x EBITDA, the positive effect on the market capitalizations of both companies could reach 8%. With no clear consensus so far within the government ranks as to whether the merger will actually happen, a more important factor to consider in the potential valuations of PKN and Lotos are the current market conditions.

Jury Still Out On PKN-LTS Merger

The responses of decision-makers within the government ranks to the merger rumors rekindled a few days ago by local newspapers were vague and conflicting, with Deputy Energy Minister Grzegorz Tobiszowski hinting that the rumors were not entirely without basis, and Minister Tchórzewski himself saying he was not aware of any merger talks, adding he saw no economic benefits in such a transaction. Neither Lotos nor PKN have had comments so far on the reports that they both appointed coordinators to oversee the potential process. In short, it is impossible to say at this time whether there is any validity to the merger rumors.

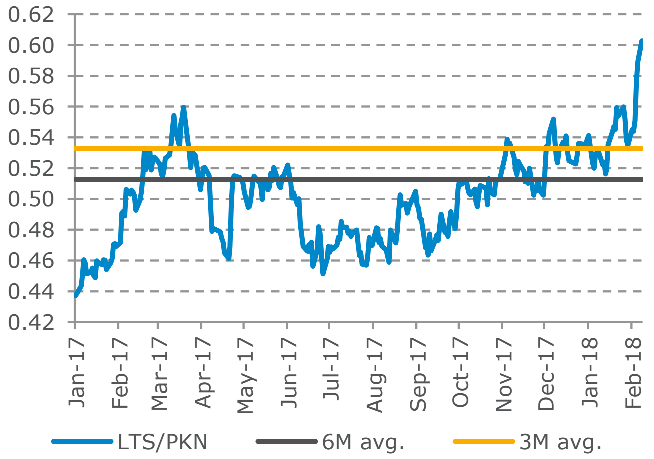
Possible Scenarios

Each of the following merger scenarios is equally probable and provided in no particular order:

- **A stock-for-stock transaction with PKN Orlen as the acquirer** would require a four-fifths majority vote by PKN shareholders, implying a bias in favor of PKN's minority shareholders when setting the stock swap ratio since the State's stake does not provide the required majority. Alternatively, investors would have to be convinced that the potential synergies are worth pursuing. Using the respective volume-weighted average prices (VWAP) for the last six months of the respective securities, the implied stock swap ratio is 1.95 LTS shares for each PKN share (at the current price level Lotos is trading about 18% above the 6-month swap ratio). Assuming all Lotos shareholders register to sell their shares to PKN in the likely tender offer, the State's direct and indirect holdings in the merged company would be 36.2%. If only the State sells its shares to PKN, its stake in the merged company would be 39.5%, giving rise to a need to hold a tender offer to increase holdings to 66%.

- **A merger by absorption** requires approval by a fourth-fifths majority if the acquirer is Lotos or a 90% majority vote if the acquirer is PKN. In this scenario the State's stake in the merged company would be 36.1%. A full integration of the two businesses would allow more flexibility in pursuing operating cost synergies.

Indicative PKN/LTS swap ratio vs. 6M & 3M avg. VWAP



Source: Bloomberg, Dom Maklerski mBanku

- **A stock–for-stock transaction with Lotos as the acquirer** would require a four-fifths majority vote by Lotos shareholders, implying a bias in favor of Lotoss minority shareholders when setting the stock swap ratio. Alternatively, investors would have to be convinced that the potential synergies are worth pursuing. A takeover by Lotos would be easier than a takeover by PKN because the State has more voting power and control over the former (including through indirectly-controlled pension- and investment funds, which hold just under 5% of Lotos's share capital). The concern here is that the State may not gain full control over PKN if it is the only one selling its shares to Lotos in a potential tender offer due to PKN's voting policies.

- **A takeover by PKN funded entirely with cash** via a tender offer for 100% of Lotos shares would require PKN to shell out about PLN 10bn, implying an increase in its net debt/EBITDA ratio to 1.5x as of year-end 2017 and further to 2.7x in FY2018E (when debt is expected to be boosted further by other factors. This is the less likely scenario given its impact on PKN's financial standing.

The Antitrust View

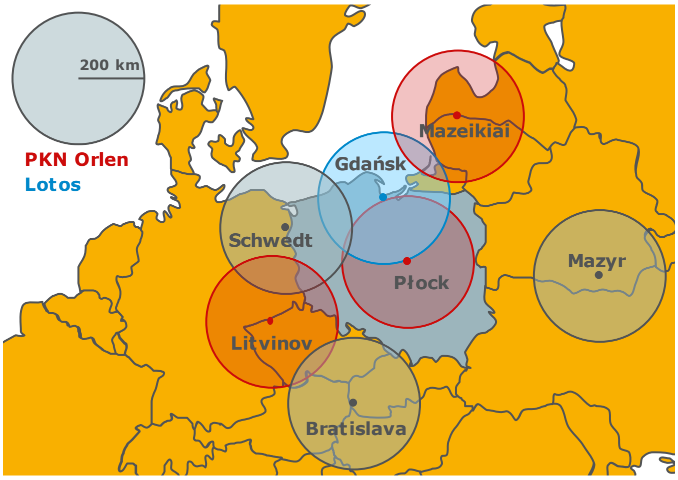
Antitrust considerations will play a crucial role in facilitating the merger of PKN and Lotos. The merged company would have a market share of 80-90% in the Polish wholesale fuel market depending on fuel type. However, the chances are that the level of market concentration will be assessed by EU regulators for a region spanning Poland and its immediate neighbors. In this case the capacity of the merged refiner would account for a more palatable 26%-or so of the combined capacities of Poland, Germany, Czech Republic, Slovakia, and Lithuania. The market share in retail fuel sales would be higher at ca. 45%, but this would not be considered an obstacle.

Synergies

The cost savings and revenue upside achievable through a merger of Poland's two largest oil companies, between them controlling 90% of the domestic market, will depend to a large extent on the ability to manage and contain labor protests – a big challenge given how much power unions wield in state-run companies, and judging by concerns voiced in the past by local governments about possible job losses and loss of tax revenues.

- **General and administrative expenses:** The potential for savings here lies in the centralization pf processes to reduce Lotos's domestic administrative expenses, reaching PLN 0.4bn a year. Based on subsidiary cost management practices used by PKN Orlen, we estimate the annual savings at PLN 0.1+ billion.

Logistics advantages of PKN & LTS refineries



Source: Dom Maklerski mBanku

- **Selling expenses:** All differences considered, using PKN benchmarks, the potential savings here can fall in the range of PLN 0.3-0.4 billion according to our rough calculations. The most obvious area for streamlining is logistics and transportation.

- **Geographic premiums:** Both PKN and Lotos reap extra profits on their dominant domestic presence a large distance away from foreign competition. The geographic premium in the north of Poland is probably smaller due to higher competition, and by merging PKN and Lotos could maximize it by dividing the market between themselves. The following table analyzes the sensitivity of the aggregated EBITDA to changes in geographic premiums affecting 25% of domestic diesel and gasoline sales (an arbitrary percentage more or less reflecting geographic reach), assuming the merged company has a 90% share in the wholesale market in the area.

EBITDA sensitivity to geographic premiums in highly competitive areas

Change in premium ($t)	5.0	10.0	15.0	20.0	25.0
Additional EBITDA (PLN m)	**78**	**156**	**233**	**311**	**389**

Source: Dom Maklerski mBanku

- **CAPEX:** Savings on capital investment could be achieved, among others, through concerted sulfur emission adjustments if Lotos uses PKN's HSFO instead of asphalt in its delayed coking unit, and through coordinated investment in petrochemicals capacity and reduced maintenance costs.

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

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