

Thursday, August 01, 2019 | update

PKN Orlen: hold (upgraded)

PKN PW; PKN.WA | Oil & Gas, Poland

It Will Get Better Before It Gets Worse

Our long-held scenario predicting a cyclical slowdown in the refining and petrochemical markets is taking longer than expected to set in, and we are once again prompted to revise our near-term outlook to adjust for the closure of a major refiner in the US, lower-than-anticipated crude prices, better profits achieved by petrochemical installations, and record-low prices of natural gas. Consequently, we feel compelled to upgrade our earnings outlook for PKN Orlen, especially after the Company generated higher-than-expected profit margins in Q2 2019 thanks to an improved refinery slate and cheaper costs of crude inputs. On the updated prospects, we raise our target price for PKN from PLN 80.01 to PLN 92.82 a share, and we upgrade the stock two notches, from sell to hold. There are no negative catalysts looming in PKN's near future looking at high refining margin benchmarks this far into the third quarter, combined with low water levels on the River Rhine, a crucial shipping route for fuels. Furthermore, consumer demand in Poland remains strong, as reflected in the healthy sales margins of fuel retailers, and prices of natural gas keep declining. To top it all, PKN is aiming for higher refinery production in the third quarter. All this makes for a robust near-term outlook for PKN, but in the longer term the picture is more cloudy, however, looking at the scale of planned global refinery expansions and considering PKN's tentative (and therefore not yet factored into our forecasts) plans for a substantial rise in capital expenditures on top of the steep price it is poised to pay for the acquisition of rival Lotos.

Third Quarter Looks Good...

PKN's model refining margin (incl. the Urals/Brent pricing differential) for the third quarter to date has averaged \$9+ a barrel compared to \$7.6 generated in Q3 2018, accompanied by more favorable USD/PLN movements. The Company has declared record quarterly throughput of 9mmt for the quarter, and this, combined with higher land premiums, makes for a stellar earnings outlook for the refining business, underpinned by still-low gas prices, coming on the heels of a positive surprise delivered in Q2. The prospects for the retail business look equally good owing to strong sales margins generated by PKN's service stations thanks to the improved spending power of Polish consumers. Consequently, even as the petrochemicals business experiences narrowing margins, PKN's LIFO EBITDA for Q3 2019 is more than likely to exceed PLN 3 billion. The current low Rhine water levels, signaling the same potential disruptions in fuel supplies as experienced in the second half of 2018, are lifting market sentiment.

But Medium-Term Outlook Less Upbeat

PKN's longer-term prospects are fraught with many challenges, not the least of which is the looming global oversupply of petroleum and petrochemical products after the planned capacity additions. Meanwhile the Polish refiner is talking about wanting to move forward with its own major projects on top of the upcoming equity investment in Lotos. We do not factor the unspecified capital projects into our valuation model for now, but our guess is that their yearly costs might go into the billions of zlotys.

(PLN m)	2017	2018	2019E	2020E	2021E
Revenue	95,364.0	109,706.0	105,332.7	106,606.0	113,873.6
EBITDA	11,078.0	9,776.0	9,077.3	8,319.4	8,407.7
EBITDA margin	11.6%	8.9%	8.6%	7.8%	7.4%
EBIT	8,657.0	7,103.0	5,637.8	4,812.2	4,868.7
Net income	6,655.0	5,463.0	4,497.1	3,819.9	3,747.2
P/E	6.3	7.6	9.3	10.9	11.1
P/CE	4.6	5.1	5.2	5.7	5.7
P/B	1.3	1.2	1.1	1.0	1.0
EV/EBITDA	4.1	4.8	5.4	5.8	5.6
DPS	3.00	3.00	3.50	3.00	3.00
DYield	3.1%	3.1%	3.6%	3.1%	3.1%

Current Price	PLN 97.36
Target Price	PLN 92.82
Market Cap	PLN 41.5bn
Free Float	PLN 28.1bn
ADTV (3M)	PLN 162.8m

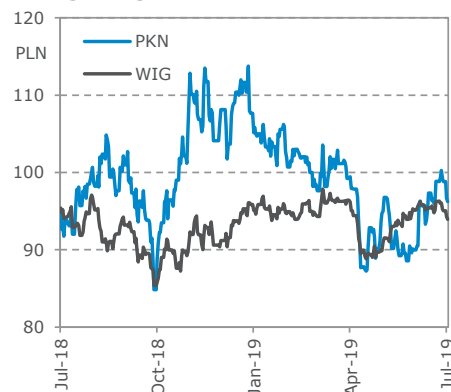
Ownership

State Treasury	27.52%
NN OFE	7.61%
AVIVA OFE	6.42%
PERN	4.90%
Others	53.55%

Business Profile

PKN Orlen is the largest refinery in the CEE region with 33mmt of annual crude processing capacity. It operates over 2,700 service stations and through produces fertilizers and petrochemicals through subsidiary units and joint-ventures, including one with LyondellBasell. In 2005, PKN Orlen acquired the Czech refiner Unipetrol, and in 2006 it took over the former Mazeikiu Nafta refinery in Lithuania. In the last few years, PKN has built a portfolio of upstream assets (mainly in Canada) with capacity for 114mmboboe.

PKN vs. WIG



Company	Target Price		Rating	
	new	old	new	old
PKN Orlen	92.82	80.01	hold	sell

Company	Current Price	9MTP	Downside
PKN Orlen	97.36	92.82	-4.7%

Forecast Update	2019E	2020E	2021E
LIFO EBITDA	+24.1%	+5.0%	-1.2%
Net profit	+25.4%	+19.0%	+7.9%
Refining margin* (\$/bbl)	+18.8%	+9.1%	+0.0%
Petchem margin (\$/t)	+5.7%	+1.3%	-0.2%
USD/PLN	+0.0%	+0.0%	+0.0%

*Incl. Urals/Brent pricing spread

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List of abbreviations and ratios contained in the report:

EV – net debt + market value
EBIT – Earnings Before Interest and Taxes
EBITDA – EBIT + Depreciation and Amortisation
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
UNDERWEIGHT (UW) – a rating which indicates that we expect the stock to underperform the broad market

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mBank issued the following investment recommendations for PKN Orlen in the 12 months prior to this publication

Rating	sell	sell	sell	sell	sell	reduce	sell	sell
Rating date	2019-06-03	2019-04-02	2019-03-05	2019-02-04	2018-11-15	2018-11-05	2018-09-03	2018-08-02
Target price (PLN)	80.01	79.39	81.22	83.43	81.52	81.38	81.38	76.84
Price on rating day	96.78	99.94	101.50	104.70	97.80	93.50	98.24	93.06

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