

Monday, August 05, 2019 | update

KGHM: reduce (downgraded)

KGH PW; KGH.WA | Metals, Poland

Copper Outlook Deteriorates On Trade War Concerns

Rising tensions between the US and China after the threat of new tariffs sent out by President Trump, coupled with theories that China wants to hold off a deal until after the 2020 US presidential elections, have raised concerns about further deterioration in economic prints in the near future. Chinese copper imports fell to their lowest level since March 2018 in June at 930,000 tonnes, down 21% year over year. At the same time, local vehicle registrations in July logged their 12th month in a row of falls, showing an 8% drop from July 2018. This on top of a 10% slump in new lending in July to 1,664 billion yuan. Analysts have been cutting their forecasts for 2019-2020 average copper prices since mid-2018. When it comes to KGHM, the downward pressure is exacerbated by expectations of worsened earnings results for Q2 2019, indicating a continuing downward slide in August in line with a general sell-off in mining stocks, underpinned by a likely downward correction in the prices of iron ore. Global stocks set to be affected by the downturn in metals prices include ANG JS, BHP AU, and RIO LN. The discount at which KGH is usually traded relative to its global peers has narrowed from an average of 20-25% to about 9% in recent weeks, an unsustainable level given the Polish miner's higher C1 production costs, lesser free-cash-flow-generating capability, and below-average dividend yields. After lowering our 2019-2021 copper price outlook to levels consistent with the median forecasts of analysts, and after downgrading expectations as to the USD/PLN exchange rate and the prices of lead, we are forced to cut our 2020-2021 EBITDA estimates for KGHM by approximately 10%. Consequently, we downgrade KGH from hold to reduce, with the 9-month price cut from PLN 98.35 to PLN 80.38 per share.

Analysts keep downgrading copper outlook

The median of analysts' forecasts for copper prices in 2019-2021 has been on a decline since mid-2018. The current consensus is for an average 2019 price of \$6,100/t, followed by a rise to \$6,300 anticipated in 2020 and further growth to \$6,650 in 2021. However, with actual market prices at the moment trading lower than the average forecast, the consensus is probably due for further downward revisions.

High production costs

KGHM incurs higher C1 costs than any other comparable copper miner in its peer group (\$1.8/lb in 2018). Consequently, its operating leverage is also above average, making the Polish producer more vulnerable to any downward shifts in copper prices.

Low FCF

KGHM has the fifth-lowest estimated 2020-2021 FCF/EV ratios in its peer group. Due to the weaker cash-generating capabilities, we predict that the dividend yield offered by the Polish firm in 2020 will be the industry's third-lowest yield for the year in the baseline scenario; in the worst-case scenario, if market conditions should deteriorate more than we are anticipating today, KGHM might hold next year's shareholder distributions altogether for the third year in a row.

(PLN m)	2017	2018	2019P	2020P	2021P
Revenue	20,275.0	20,526.0	22,543.6	21,997.9	22,866.6
EBITDA (adj.)	5,753.0	4,972.0	5,184.3	4,385.0	4,826.8
EBITDA margin	28.4%	24.2%	23.0%	19.9%	21.1%
EBIT (adj.)	4,144.0	3,176.0	3,331.1	2,452.7	2,842.9
Net profit (adj.)	1,792.0	1,887.9	2,304.3	1,619.5	1,915.0
P/E (adj.)	9.8	9.3	7.6	10.8	9.2
P/CE	5.7	5.1	4.2	4.9	4.5
P/B	1.0	0.9	0.8	0.8	0.7
EV/EBITDA (adj.)	4.2	5.0	4.2	4.9	4.3
DPS (PLN)	1.00	0.00	0.00	1.50	2.43
Dividend Yield	1.1%	0.0%	0.0%	1.7%	2.8%

Current Price	PLN 87.78
Target Price	PLN 80.38
Market Cap	PLN 17.5bn
Free Float	PLN 9.9bn
ADTV (3M)	PLN 100.4m

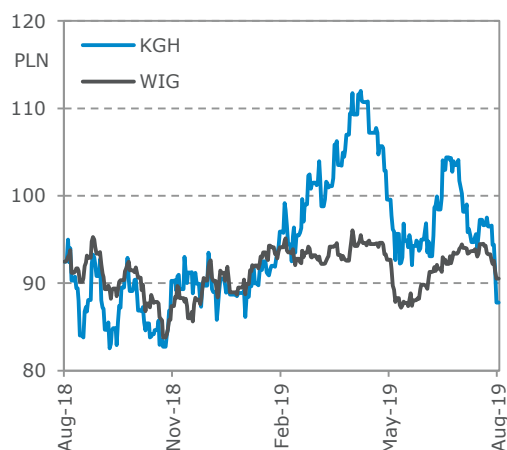
Ownership

State Treasury	31.79%
OFE NN	7.37%
OFE Aviva	5.25%
Others	55.59%

Business Profile

KGHM is the eighth-largest copper producer in the world, and it ranks as #1 in the production of silver. As a copper producer, it is in the third quartile on the global cost curve. The Company extracts and refines copper in facilities based in Poland, Chile (Sierra Gorda), the US (Robinson & Carlota mines), and Canada (Ajax, Sudbury, Victoria).

KGH vs. WIG



Company	Target Price		Rating	
	new	old	new	old
KGHM	80.38	98.35	reduce	hold

Company	Current Price	Target Price	Downside
KGHM	87.78	80.38	-8.4%

Forecast Update	2019E	2020E	2021E
EBITDA (adj.)	+0.3%	-13.7%	-10.6%
Net Profit (adj.)	+0.7%	-24.8%	-18.6%
Copper price (\$/t)	-3.9%	-3.1%	-2.2%
Silver price (\$/oz)	+3.2%	+3.2%	+3.2%
Molybdenum price (\$/t)	+0.4%	0.0%	0.0%
Copper output (kt)	0.0%	0.0%	0.0%
Silver output (tonnes)	0.0%	0.0%	0.0%
Molybdenum (Mlb)	0.0%	0.0%	0.0%

Analyst:

Jakub Szkopek
+48 22 438 24 03
jakub.szkopek@mbank.pl

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 KGHM in the 12 months prior to this publication

Rating	hold	hold	hold	hold	hold	hold	buy	buy
Rating date	2019-07-03	2019-06-03	2019-04-02	2019-02-04	2018-12-05	2018-10-15	2018-09-03	2018-08-02
Target price (PLN)	98.35	91.71	105.57	92.41	84.56	87.99	104.21	111.08
Price on rating day	101.70	95.00	109.40	94.16	92.60	85.40	90.80	96.00

Dom Maklerski mBanku

Senatorska 18
00-082 Warszawa
<http://www.mbank.pl/>

Research Department**Kamil Kliszcz**

director
+48 22 438 24 02
kamil.klischcz@mbank.pl
energy, power generation

Jakub Szkopek

+48 22 438 24 03
jakub.szkopek@mbank.pl
industrials, chemicals, metals

Aleksandra Szklarczyk

+48 22 438 24 04
aleksandra.szklarczyk@mbank.pl
construction, real-estate development

Michał Marczak

+48 22 438 24 01
michal.marczak@mbank.pl
strategy

Paweł Szpigiel

+48 22 438 24 06
pawel.szpigiel@mbank.pl
media, IT, telco

Piotr Poniatowski

+48 22 438 24 09
piotr.poniatowski@mbank.pl
industrials

Michał Konarski

+48 22 438 24 05
michal.konarski@mbank.pl
banks, financials

Piotr Bogusz

+48 22 438 24 08
piotr.bogusz@mbank.pl
retail, gaming

Mikołaj Lemańczyk

+48 22 438 24 07
mikolaj.lemanczyk@mbank.pl
financials

Sales and Trading**Traders****Piotr Gawron**

director
+48 22 697 48 95
piotr.gawron@mbank.pl

Jędrzej Łukomski

+48 22 697 49 85
jedrzej.lukomski@mbank.pl

Tomasz Galanciak

+48 22 697 49 68
tomasz.galanciak@mbank.pl

Krzysztof Bodek

+48 22 697 48 89
krzysztof.bodek@mbank.pl

Adam Prokop

+48 22 697 47 90
adam.prokop@mbank.pl

Magdalena Bernacik

+48 22 697 47 35
magdalena.bernacik@mbank.pl

Tomasz Jakubiec

+48 22 697 47 31
tomasz.jakubiec@mbank.pl

Andrzej Sychowski

+48 22 697 48 46
andrzej.sychowski@mbank.pl

Sales, Foreign Markets**Marzena Łempicka-Wilim**

deputy director
+48 22 697 48 82
marzena.lempicka@mbank.pl

Bartosz Orzechowski

+48 22 697 48 47
bartosz.orzechowski@mbank.pl

Private Client Sales**Kamil Szymański**

director
+48 22 697 47 06
kamil.szymanski@mbank.pl

Jarosław Banasiak

deputy director
+48 22 697 48 70
jaroslaw.banasiak@mbank.pl