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PKN Orlen: Notes on 'ORLEN2030' Strategy Targets

Rating: hold | target price: PLN 56.37 | current price: PLN 56.32

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In its ORLEN2030 agenda, unveiled on Monday, PKN Orlen sets the 2030 EBITDA target at a very ambitious PLN 26bn, to be achieved through massive capital investment (PLN 140bn), underpinned by what we view as highly optimistic assumptions about economic fundamentals.

When it comes to how the updated agenda might change the earnings consensus, we do not see analysts as instantly incorporating Orlen's ambitions into their models considering the lack of details as regards the costs and expected returns of planned capital projects. Similarly, Orlen's presentation does not specify any potential EBITDA-shaping milestones that could be transformative to how the market currently sees the Company's future.

The allocation of the capital spend between developing sustainable energy sources and increasing capacity in petrochemicals and retail is smart but nothing new.

The single biggest takeaway from the ORLEN2030 release, which sent PKN stock soaring on Monday, is a dividend declaration of no less than PLN 3.5 a share to be paid out from annual earnings starting from 2021, implying a dividend yield of ~6%, which has pushed aside any concerns (in our view justified) about Orlen's future FCF generation potential. Meanwhile we have to point out that, if PKN were to complete the planned merger share swap with Lotos at today's market prices, a 3.5 zloty dividend would require total yearly cash distributions of PLN 1.9 billion minimum – a big challenge considering that the current combined EBITDA generating potential of the two companies is about PLN 10 billion.

PKN could more easily keep its dividend commitment if it also combines its business with the more cash-rich PGNiG, although to make a 3.5 zloty DPS would take a total payout of PLN 3.6bn vis-à-vis the estimated EBITDA potential of the merged company of PLN 17-18 billion, and its total yearly CAPEX of no less than PLN 15bn not even counting the ambitious ORLEN2030 ventures.

When approached in this way, we see an inherent risk present in PKN's dividend policy which investors are bound to notice sooner or later as soon s they turn their attention to the sanguine economic assumptions that underlie the ORLEN2030 vision. Other than an eventual rebound in refining margins from their current low levels, which in our view is fully priced in, we currently do not see any upside in PKN stock.

Earnings Targets to 2030

Orlen expects to grow **EBITDA** to PLN 26bn in 2030 from PLN 9bn generated in 2019, supported by contributions from Lotos and Energa.

Cumulative earnings in the 2020-2030 period are expected to reach PLN 195bn, with **average annual EBITDA at PLN 17.7bn** as compared with a combined **PLN 10bn between them expected to be achieved in 2020 by Orlen and Lotos**.

CAPEX through 2030 is planned at PLN 140bn, implying **average annual spend of PLN 12.7bn versus a sum total of PLN 6.2bn spent in the year to 30 September 2020 by Orlen and Lotos**.

Orlen declares in the 2030 agenda that it will pay **dividends of no less than PLN 3.5 a share from 2021**, and it intends to maintain the net debt/EBITDA ratio in the range of 2.0-2.5x. When it comes to financing methods, among others Orlen wants to utilize project finance and hybrid bonds which will not count towards the leverage ratio.

Refining

Orlen aims to grow segmental **EBITDA** from Refining from PLN 2.8bn in 2019 to **PLN 7bn**, which compares to **our forecast of PLN 4.4bn including Lotos**.

Segmental **CAPEX** in the 2021-30 period is set at **PLN 2.4bn** per year (including investment to expand biofuel capacity from 0.3 to 2 million tonnes) versus **PLN 2.7bn assumed by us after factoring in Lotos and investment in power generation capacity**.

The **refining capacity** is expected to increase from 36mmt in 2019 to a target 45mmt with the acquisition of Lotos.

Petrochemicals

EBITDA in the Petrochemicals segment is set to increase from PLN 2.3bn in 2019 to approximately **PLN 7bn** in 2030 **(versus our prediction of PLN 1.6bn segmental EBITDA)**.

Annual **CAPEX** here is expected to **average PLN 4.4bn** in 2020-2030 **(we assume PLN 1.0bn)** – money allocated among others to growing the share of specialty products in the sales mix from 16% to 25% vs 16%, and to building plastics recycling capacity of 0.3-0.4mmt.

Energy

Orlen expects to grow **earnings** from power generation to **PLN 7bn** in 2030 from PLN 1.6bn in 2019 **(our 2030 forecast is PLN 4.1bn, but it does not include offshore wind farms).**

This after **investing PLN 4.7bn on average** per year in 2021-30 **(vs. PLN 1.7bn assumed by us)** to develop renewable energy sources, with total RES capacity set to increase from 0.5 to 2.5GW, of which 1.7GW in offshore wind (presumably after acquiring licenses to add to the 1.2GW secured to date), 0.8GW in onshore solar plants, and more than 2GW in gas fired power (currently at 1.1GW).

Retail

In Retail, the goal is for **EBITDA** to reach **PLN 5bn** vs. PLN 3.1bn in 2019 **(we have a 2030 forecast of PLN 3.6bn for Retail incl. Lotos).**

This after average yearly **investment of PLN 1.1bn (a figure consistent with our forecast incl. Lotos).**

Orlen wants to **expand** the service station network from 2,800 to 3,500 locations, including by entering two more foreign markets to increase the share of foreign sites in total from 37% to 45%. At the same time, the Company plans to grow the non-fuel business and increase the gross non-fuel margin 1.5 times by 2030.

Upstream

EBITDA from Upstream is forecast to increase from PLN 0.2bn to **PLN 1bn (vs. PLN 0.6bn forecast by us).**

With annual **investment of PLN 0.9bn (the same as our estimate incl. Lotos),** Orlen aims to increase daily hydrocarbon production from 18 to 50 thousand barrels (vs. our 35kpd forecast), enough to supply 20% of its own gas demand.

Macroeconomic Assumptions

The following table gives an overview of the assumptions underlying the ORLEN2030 targets set against our own forecasts for the period and actual average values registered in 2019 and 2020. When it comes to refining margins, the room for error is obviously high for predictions spanning a ten-year horizon, but using our best judgment we would say that Orlen used overly optimistic projections for virtually all business areas with its margin targets set well above the average values reached in 2019 and in a long-term period.

Macroeconomic assumptions underlying the 'ORLEN2030' Strategy vs. mBank projections and 2019-2020 actuals

	Actual Avg. Value		ORLEN2030		mBank Forecast		Difference	
	2019	2020	2021-25	2026-30	2021-25	2026-30	2021-25	2026-30
Urals/Brent differential ($/bbl)	0.9	0.5	1.5	2.1	1.5	1.5	-1%	+40%
Model refining margin ($/bbl)	5.17	2.1	4.1	4.9	3.9	4.5	+5%	+9%
Model petrochemical margin (EUR/t)	858.7	843	884.0	1113.0	731.0	731.0	+21%	+52%
Price of Brent oil ($/bbl)	64	42	57.8	79.4	48.0	50.0	+20%	+59%
Price of natural gas in Poland (PLN/MWh)	72.2	50.1	71.6	95.6	69.9	72.6	+2%	+32%
Price of emission allowances (EUR/t)	25.19	24.7	34.0	48.9	34.2	46.4	-1%	+5%
Wholesale electricity price (PLN/MWh)	239.3	266.7	274.0	349.3	253.2	277.7	+8%	+26%

Source: PKN Orlen, mBank

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
UNDERWEIGHT (UW) – a rating which indicates that we expect the stock to underperform the broad market

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