

KGHM**Neutral**

TP: PLN 109

- Rating upgrade to Neutral rating from Reduce with 12M TP up to PLN 109
- 2015 net profit forecast down 15%YoY to PLN 2.2bn
- 2015 P/E 9.2x in line with 3yr average

Dollar comes to the rescue

As copper prices hit 5-year lows, we are changing our stance on KGHM, arguing that further copper downside is limited while strengthening dollar offers a hedge and potential upside. We are upgrading KGHM to Neutral from Reduce and increase our 12M TP to PLN 109 from PLN 107. Marking to market our 2015E copper price (at USD 5,600/t) and USDPLN assumptions (at 3.66), we expect KGHM's 2015E consolidated earnings to drop by 15% YoY to PLN 2.2bn. This implies 2015E P/E of 9.2x, in line with 3yr average and a 20% discount to its peers. We believe the near end of the ramp up phase of Sierra Gorda could be a trigger that should narrow KGHM's discount to its peers. Finally, we expect DPS of PLN 4.2, a 4.2% yield which should also provide some cushion.

Copper and silver hit multiyear lows. Throughout last 3 months copper lost 13% with 12% drop YTD and is trading at the lowest levels since 2009 with record high volumes of speculative short positions. We believe that supply disruptions, delays of new mines combined with demand from power grid investment in China and RoW will provide floor for copper in the remainder of 2015.

Strong USD partially offsetting copper price decline. USD appreciation is supportive for KGHM domestic business, as current PLN denominated copper price of PLN 20.5k/t is still just 5% lower than 2014 average despite 17% lower price in USD.

We expect 15%YoY drop in consolidated earnings in 2015E to PLN 2.2bn. Mostly due to higher assumed silver and copper volumes we have lifted our 2014 NP by 24% to PLN 2.6bn. As we cut our 2015E copper price assumption to USD/t 5,600 from USD/t 6,831, with favorable USDPLN at 3.66 we expect KGHM to deliver 2015 net profit of PLN 2.2bn, down 15% YoY. With growing contribution of SG in 2016 we expect net profit to grow by 11% to PLN 2.4bn.

Valuation. Our new 2015E EPS forecast implies P/E of 9.2x, in line with its 3yr average and 20% below the peer group. We value KGHM using a combination of: (1) peer comparison with 10% discount to average 2015E and 2016E multiples of copper producers, yielding PLN 101 per share; and (2) sum of parts DCF valuation which yields PLN 96 per share. Our 12-month target price TP is PLN 109, 8% above current market price.

Triggers and Risks. We believe that Sierra Gorda becoming fully operational in mid-2015 should be a company-specific trigger that should narrow KGHM's discount to its peers. The main risk for our rating is the possibility of hard landing in Chinese economy.

Figure 1. KGHM: Financial forecast and valuation

		2012	2013	2014E	2015E	2016E
Revenues	PLN m	26 705	24 110	20 500	20 336	20 527
EBITDA	PLN m	8 199	5 952	5 472	4 860	5 335
Net profit	PLN m	4 753	3 033	2 583	2 186	2 427
EPS	PLN	23.8	15.2	12.9	10.9	12.1
DPS*	PLN	9.8	5.0	4.2	3.5	4.9
P/E (x)	x	6.1	9.4	7.9	9.2	8.4
EV/EBITDA (x)	x	2.8	5.4	4.3	5.0	4.6

Source: Company data, DI Investors estimates, *from earnings in a given year

Company data

Target Price (PLN)	109
Previous target price	107
Share Price (PLN)	101
Upside	8%
Min (52W)	100
Max (52W)	138
No. of shares (m)	200
Market cap (PLN m)	20190
Net debt 3Q2014 (PLN m)	3555
EV (PLN m)	23745
Avg. 3M Turnover (PLN m)	99

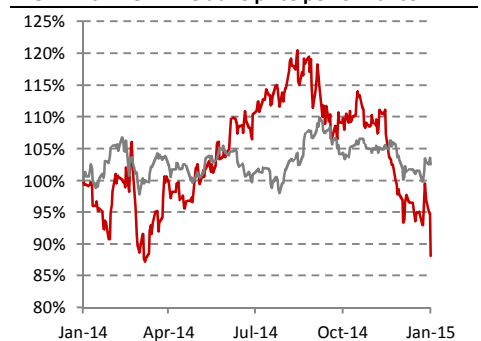
Shareholders

State Treasury	31.8
Others	68.2

Company description

KGHM is the 10th largest refined copper producer with 571kt output in 2012 (3% global supply). It is also the world's biggest silver producer. The core Polish underground mines extract c.420kt, while in 2012 KGHM diversified to the Americas, buying Quadra FXN. It currently runs the 55% owned greenfield open pit Sierra Gorda project in Chile (230kt target output, 20y LOM, feasible as of 2014). Polish assets are in the 3rd quartile of the global cost curve with Sierra Gorda assumed to fit into the 1st. KGHM aims to expand its own production to 700kt.

KGHM vs WIG 1Yr relative price performance



Source: Bloomberg

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The recommendation system of DI Investors is based on determination of target prices and their relations to current prices of financial instruments; in addition, when recommendations are addressed to a wide range of recipients, two methods of valuation are required.

In preparing this document DI Investors applied at least two of the following valuation methods:

- 1) discounted cash flows (DCF),
- 2) comparative,
- 3) target multiple,
- 4) scenario analysis,
- 5) dividend discount model (DDM),
- 6) NAV,
- 7) Sum of the parts.

The discounted cash flows (DCF) valuation method is based on discounting expected future cash flows. The main advantage of the DCF valuation is the fact that this method takes into account all cash streams the issuer is expected to reach and the cost of money over time. From the other hand, DCF valuation method requires a number of assumptions and is very sensitive to changes in parameters used in the model. Small changes in inputs can result in large changes in the value of a company.

The comparative valuation method is based on the rule of "one price". The advantages of this method are small number of parameters that need to be estimated, the fact that there is a relatively large number of indicators for companies being compared, the method is well-known among investors and the valuation is based on current market conditions. From the other hand a valuation derived from the comparative valuation method is considerably sensitive to the valuation of the companies classified as peers and can lead to simplification of the picture of the company.

The target multiple valuation approach is based on the assumption that the value of the company should be equal to pre-specified values of selected price multiples. The advantage of this method is its applicability to each company. From the other hand the target multiple approach is a highly subjective method.

The scenario analysis approach is based on the probability weighted valuation for three sets of assumptions: Bear case (20% probability), base case (60% probability) and bull case (20% probability). The base case is based on the assumptions and estimates which we have included in our financial forecasts and DCF valuation. In the bear/bull case scenarios we have analyzed the valuation sensitivity towards negative/positive changes in various assumptions including market size, market shares, profitability, growth, capex, valuation multiples etc. The advantage of this method is presentation of various scenarios and valuation sensitivity. As an disadvantage we find its complication and sensitivity towards probability weights assumption.

The dividend discount model (DDM) valuation uses predicted dividends that are expected to be paid out by the company and discounts them back to present value. The advantages of the DDM valuation method are its applicability to companies with long-term dividend payout history and the fact that it takes into account real cash streams that are expected to receive by equity-owners. From the other side the DDM valuation method requires a number of assumptions regarding dividend payouts.

The net asset value approach considers the underlying value of the company's individual assets net of its liabilities. Some of the advantages of the NAV approach are its applicability to asset holding companies and the fact that data required to perform the valuation are usually easily available. From the other hand the valuation derived from net asset value approach does not take into account future changes in sales or income and can understate the value of intangible assets.

The sum of the parts approach values a company by determining what its divisions would be worth if it was broken up and spun off or acquired by another company. The advantage of this method is a possibility to apply different valuation methods to different divisions. As an disadvantage we find scarcity of comparable basis for the respective business lines.

Terminology used in the recommendation:

P/E – price-earnings ratio

PEG - P/E to growth ratio

EPS - earnings per share

P/BV – price-book value

BV – book value

EV/EBITDA – enterprise value to EBITDA

EV – enterprise value (market capitalization plus net debt)

EBITDA – earnings before interest, taxes, depreciation, and amortization

EBIT – earnings before interest and tax

NOPAT – net operational profit after taxation

FCF - free cash flows

ROE – return on equity

WACC - weighted average cost of capital

CAGR – cumulative average annual growth

CPI – consumer price index

COE – cost of equity

L-F-L – like for like

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Buy - indicates a stock's total return to exceed more than 1.5x respective cost of equity over the next twelve months.

Accumulate - indicates a stock's total return to exceed more than respective cost of equity over the next twelve months.

Neutral - indicates a stock's total return to be in range of 0% to respective cost of equity over the next twelve months.

Reduce - indicates a stock's total return to be in range of minus respective cost of equity to 0% over the next twelve months.

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