Industrial | Poland

PKP Cargo

Reduce
TP PLN 60

- **We cut 2015-2016E freight turnover forecast by 1.9% and 2.5%**
- **Our 2015-2016E adj.net profit estimates down 14% and 29% to PLN 198m and PLN 197m, 7% and 22% below consensus**
- **2016E adj. P/E of 15.1x and adj. EV/EBIDA of 5.7x**

Vestor DOM MAKLERSKI
equity research

2 November 2015

More negative on 2016 volumes and salary costs

We are downgrading our rating for PKP Cargo (PKPC) to Reduce from Neutral, lowering our 12M TP to PLN 60 from PLN 78. First, we are trimming our 2015-2016E freight turnover estimates by 1.9% and 2.3%, respectively, mainly on the back of a decline in PKP's domestic market share and lower coal volume estimates. Second, we are increasing our salary cost estimates yet again, following trade unions' call for a general strike. Due to lower turnover, expected salary hike, and more conservative estimates regarding AWT, we are cutting our 2016E adj. EBITDA and adj. net profit forecasts by 12% and 29% to PLN 740m and PLN 197m, respectively. Our new 2016E EBITDA and net profit estimates are 9.3% and 22.5% below consensus and imply PKPC's EV/EBITDA and P/E multiples at 5.7x and 15.1x, which we find demanding.

Domestic market remains challenging. According to UTK, in September PKPC experienced a 3.6% YoY drop in freight turnover with market share below 55% for the second consecutive month. YTD, PKPC's domestic turnover is down 2% YoY, which forced us to reduce 2015E turnover estimate by 1.9% to 28.3bn tkm. We remain cautious on 2016E volumes, which we now expect to stay flat due to declining coal volumes. Overall, this translates into PLN 100m cut to our 2016E top line estimates.

Trade unions call for a general strike. On October 30th, PKPC's trade unions called for a general strike to be held on November 9th unless management agrees to a PLN 120m annual salary hike (compared to PLN 50m already granted in July). Given current political environment, we assume the management will meet the demands half way – and we add PLN 35m to salary costs starting from 2016E.

Cutting forecasts. We cut our 2015E and 2016E adj. EBITDA estimates by 3.5% and 12.1% to PLN 696m and PLN 740m respectively, mostly on the back of lower freight turnover and higher salary costs. We also note higher risk to AWT earnings after 2016E, given the company's reliance on NWR's coal volumes. We cut our 2015E and 2016E adj. net profit estimates by 13.8% and 29.2% to PLN 198m and PLN 197m, respectively. Our new 2015-2016E net profit estimates are 7% and 22% below consensus.

Valuation. On our new estimates PKPC is trading at 2015-2016E adj. EV/EBITDA of 5.6x and 5.7x with adj. P/E of 15.0x and 15.1x, respectively, which we find demanding despite an expected rebound in domestic cargo market in 2017. Based on DCF, we set our new 12m target price at PLN 60, 10% below current share price.

PKP Cargo: Financial summary

		2013	2014	2015E	2016E	2017E
Sales	PLN m	4 797	4 257	4 555	4 749	4 958
Adj.EBITDA	PLN m	708	680	696	740	832
Adj.net profit	PLN m	210	250	198	197	262
DY	%	n.a.	3.7%	3.7%	3.3%	3.3%
Adj. P/E	x	17.6	14.7	15.0	15.1	11.4
Adj. EV/EBITDA	x	4.8	5.2	5.6	5.7	5.3

Source: Vestor DM research estimates

Company data

Target Price (PLN)	60.0
Share Price (PLN)	66.4
Downside	10%
Min (52W)	63.5
Max (52W)	93.2
No. of shares, diluted (m)	44.8
Market cap (PLN m)	2 974
Adj.net debt (PLN m)	956
EV (PLN m)	3 930
Avg. 3M turnover (PLN m)	2.7

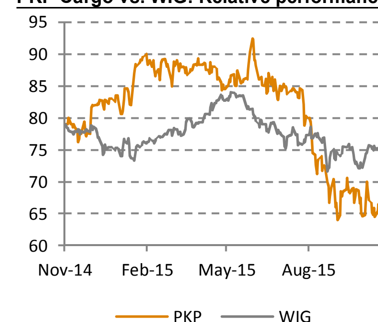
Shareholders

Treasury	33.0%
ING OFE	10.6%
Morgan Stanley	5.3%
OFE Aviva	5.2%
Others	45.9%

Company description

PKP Cargo is the largest Polish and 2nd biggest rail freight operator in the EU with transported volume of 116.7mt and freight turnover of 29.9bn tkm in 2012. Besides rail freight, PKP Cargo provides over 1,000 clients with comprehensive logistic services such as forwarding, siding maintenance and terminal services. In addition to the domestic market, the company is prepared for operation in other rail freight markets such as Germany, Austria, Slovakia, Czech, Belgium and is ready to enter Hungary.

PKP Cargo vs. WIG: Relative performance



Source: Bloomberg

Piotr Nawrocki, CFA
(+48) 22 378 9214
Piotr.Nawrocki@investors.pl

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Vestor emphasizes that this document is going to be updated at least once a year.

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Over last twelve months, Vestor issued two neutral and one reduce recommendations concerning PKP Cargo. Reduce dated 11th December 2014 with target price 78PLN. Neutral dated 4th February 2015 with target price 97PLN. Neutral dated 12th August 2015 with target price 78PLN. Vestor may act as a market maker for the shares of PKP Cargo now and in the future.

In the case where recommendation refers to several companies, the name “Issuer” will apply to all of them.

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Buy/Accumulate/Neutral/Reduce/Sell – means that, according to the authors of this document, the stock price may perform materially better/better/neutrally/worse/materially worse than the cost of equity of the respective stock.

The recommendation system of Vestor 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 Vestor 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.

8) Discounted residual income model

9) ROE-P/BV model

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 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.

The discounted residual income model valuation is based on discounted excess equity flows the company is able to deliver. The main advantage of this method is that it is based on return on equity adjusted by cost of equity. The important disadvantage is that it is based on the income statement so does not include actual cash flows, but may fluctuate depending on accounting method.

The ROE-P/BV model valuation is based on the regression line with valuation-to-book value (P/BV) depending on the return on equity the company is able to deliver. The main advantage of the method is that it includes the correlation of valuation with profitability. The main disadvantage is that it does not fully take into account earnings dynamics.

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

Recommendation definitions:

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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