PKP Cargo

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Operating margins under pressure in 2020E?

Michał Sopiel, *Equity Analyst*

+48 22 586 8233, michal.sopiel@santander.pl

3Q19 results review & investors' meeting take-aways

P&L. PKP Cargo reported the 3Q19 results in line with the preliminary figures. For more details please refer to the dedicated table (3Q19 results review). We estimate the unit revenues at PLN0.179, +6.6% y/y increase (or +1.4% q/q). The labour related costs amounted to PLN403mn in 3Q19 (+4.8% y/y) vs. PLN453mn in 2Q19. We point, however, the 3Q19P EBITDA was inflated by a (1) PLN24.4mn one-off attributable to tax provision write up and (2) IFRS16 impact (positive PLN34mn in 3Q19P vs. 3Q18).

Carriage statistics. With respect to segments performance, only intermodal reported almost 9% y/y transport performance increase in 3Q19. The remaining transport categories contracted y/y with building materials and metals standing out negatively (-37% / -23.5% y/y change respectively). The transport turnover on the group level fell 16% y/y in 3Q19.

Capex. 3Q19 capex stood at PLN250mn (or PLN289mn including IFRS16) implying PLN802mn ytd. Majority of capex was spent on locomotive modernization (PLN209mn ytd) and wagons' repairs (PLN339mn ytd).

Cash balance. The OCF amounted to PLN208mn, we estimate, which points to roughly flat delivery y/y (PLN563mn ytd). Based on our calculations, the net debt increased to PLN1.95bn in the end of September from PLN1.76bn in the end of June (+ ca. PLN189mn q/q). In the effect the net debt / LTM EBITDA ratio increased to 2.1x in the end of 3Q19 (1.88x in the end of June 2019).

Summing up, the major costs categories came in line with the expectations. The positive deviation to our PLN221mn 3Q19 EBITDA forecast results from the positive one-off related to tax provision write-up (reflected by the inflated other operating revenues). The y/y dynamic of the unit revenues at ca. 6.6% is a continuation of the tendency observed already in 1H19 but we expect the momentum to decline in coming quarters due to a high-base effect. We negatively perceive a significant q/q leverage growth despite relatively solid OCF delivery.

Investors' meeting. PKP Cargo held an investor meeting today. There are key take-aways:

- Volume outlook remains vague: both the magnitude and timing of the anticipated revival of aggregates / building materials transportation volume are hard to predict; the metals and ores segment may be negatively affected by the lowered transportation volume to Arcelor Mittal in Kraków (up to 2mnt in FY20E);
- The fixed costs are difficult to reduce (there were no hints disclosed on potential action plan); PKP Cargo should continue to focus on elimination of inefficiencies and improvement of the operational efficiency;
- PKP Cargo Connect and PKP Cargo International (AWT previously) contributed visibly to the consolidated operational margins in 3Q19;

- Capex in FY19 (to-date) was spent in majority for maintenance / modernisation of the rolling stock; PKP Cargo expects the capex for development of the new business segments to intensify in coming quarters;
- FY19E capex may come above the FY19E EBITDA (PLN925mn based on the PKP Cargo's updated guidance);
- The increase of minimal wage in FY20E may translate into additional (on the y/y) labour-related expenditure at PLN10mn in FY20E, all other things unchanged;
- Unit cost of access to the infrastructure should remain flat y/y in FY20E; the company awaits higher electricity costs next year(by approx. PLN35mn assuming flat y/y carriage turnover).

Outcome: negative. We expect PKP Cargo could continue to face unsupportive business environment next year (at least in 1H20E) due to vague volumes outlook. The unclear prospects for the building materials' segment might translate into pressure on unit revenues (in the view of lowered demand for cargo carriage) which, coupled with the feeble volumes delivery, might put at risk a perspective of top-line rebound next year. Above all, the operating margins might be burdened by (1) higher labour related expenditures (presumably +PLN73mn y/y) and (2) increased electricity costs (already mentioned PLN35mn). All in all, we see downward risks to our current FY20E EBITDA forecast at PLN1,060mn. The higher determination aimed at fixed costs reduction (i.a. introduction of the variable/incentive component to the salaries' scheme) or review of the capex plans might turn supportive in the mid run, we reckon.

Fig. 1. PKP Cargo: 3Q19 results review

	3Q18	4Q18	1Q19	2Q19	3Q19	y/y	q/q	3Q19P	% dev.	SANe	Cons.
Sales	1,329	1,344	1,261	1,164	1,191	-10.4%	2.3%	1,191	0%	1,233	1,229
EBITDA	279.0	205.4	258.5	191.6	263.0	-5.7%	37.3%	263.0	0%	221.0	230.9
EBITDA margin	*21.0%*	*15.3%*	*20.5%*	*16.5%*	*22.1%*	*1.1*	*5.6*	*22.1%*	*0.0%*	*17.9%*	*18.8%*
EBIT	141.8	1.9	86.9	15.0	80.9	-42.9%	439.3%	80.9	0%	49.0	52.6
EBIT margin	*10.7%*	*0.1%*	*6.9%*	*1.3%*	*6.8%*	*-3.9*	*5.5*	*6.8%*	*0.0%*	*4.0%*	*4.3%*
Net profit	104.7	-10.3	53.1	-5.2	50.8	-51.5%	n.a.	50.8	0%	25.3	32.9
Net margin	*7.9%*	*-0.8%*	*4.2%*	*-0.4%*	*4.3%*	*-3.6*	*n.a.*	*4.3%*	*0.0%*	*2.1%*	*2.7%*

*Source: Company data, Santander Brokerage Poland, *3Q19P operating margins not adjusted for one-offs*

Fig. 2. PKP Cargo: 3Q19 operational results review

	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	y/y	q/q
Solid fuels	2.7	2.9	2.8	2.6	2.6	2.9	2.7	2.4	2.4	-6.7%	3.5%
Solid fuels (hard coal)	2.3	2.6	2.4	2.3	2.2	2.4	2.3	1.9	2.1	-6.4%	6.4%
Aggregates and building materials	1.9	1.6	1.6	1.8	2.0	1.8	1.4	1.4	1.3	-37.0%	-5.1%
Metals and ores	0.9	1.0	1.0	1.0	0.9	0.9	0.9	0.8	0.7	-23.5%	-10.1%
Chemical products	0.6	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5	-9.7%	-8.6%
Liquid fuels	0.4	0.3	0.2	0.3	0.3	0.3	0.2	0.2	0.3	-18.9%	9.2%
Timber and agricultural produce	0.4	0.5	0.4	0.3	0.3	0.4	0.3	0.3	0.2	-27.4%	-9.1%
Intermodal transport	0.8	0.9	0.9	1.0	1.0	1.1	1.0	0.9	1.1	8.8%	16.3%
Other	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.2	0.2	-5.9%	10.7%
Total	**7.9**	**8.1**	**7.6**	**7.8**	**7.9**	**8.1**	**7.2**	**6.6**	**6.7**	**-16.0%**	**0.9%**

Source: Company data, Santander Brokerage Poland

Fig. 3. PKP Cargo: FY19 guidance

	PKP Cargo (as of Nov 19)	PKP Cargo (as of Mar19)	% chng.	SANe	% dev.	Consensus	% dev.
Sales	n.a.	n.a.	n.a.	5,019	n.a.	5,244	n.a.
EBITDA	925	1,151	-20%	926	0%	954	-3.1%
EBITDA margin	*n.a.*	*n.a.*	*n.a.*	*18.4%*	*n.a.*	*18.2%*	*n.a.*
Capex	n.a.	n.a.	n.a.	869	n.a.	937	n.a.

Source: Company data, Santander Brokerage Poland

Fig. 4. PKP Cargo: valuation multiples summary

PLNmn	2015	2016	2017	2018	2019E	2020E	2021E
P/E (x)	32.9	n.a.	43.7	13.3	6.8	4.3	5.1
EV/EBITDA (x)	6.8	6.8	5.8	3.9	3.6	3.2	3.2
DY	3.1%	0.0%	0.0%	0.0%	6.5%	0.0%	0.0%

Source: Company data, Santander Brokerage Poland

Financial summary

Fig. 5. PKP Cargo: Income statement forecasts

PLNmn	2015	2016	2017	2018	2019E	2020E	2021E
Operating revenue	**4554**	**4411**	**4739**	**5237**	**5019**	**5385**	**5280**
Operating expenses	**4498**	**4543**	**4584**	**4960**	**4781**	**5036**	**4977**
Depreciation	649	622	547	629	688	711	722
Raw materials & supplies	697	675	706	781	759	859	831
External services	1501	1573	1573	1725	1415	1490	1418
Employee benefits	1485	1442	1509	1651	1746	1785	1817
Other operating expenses	166	231	248	174	172	191	188
EBITDA	**705**	**490**	**702**	**907**	**926**	**1060**	**1025**
EBITDA adjusted*	**637**	**553**	**702**	**907**	**808**	**942**	**907**
Operating profit	**56**	**-132**	**155**	**278**	**238**	**350**	**303**
Operating profit adjusted*	**165**	**-33**	**128**	**250**	**221**	**333**	**286**
Net financials	**-52**	**-22**	**-39**	**-42**	**-74**	**-76**	**-77**
Financial revenue	15	39	20	16	13	12	13
Financial expenses	66	61	60	58	88	88	89
Share in the profit of associates	4	3	1	4	4	4	4
One-off items	2	0	0	4	4	4	4
PBT	**11**	**-151**	**116**	**244**	**172**	**281**	**235**
PBT adjusted*	**120**	**-52**	**89**	**216**	**155**	**264**	**218**
Income tax	-20	-17	35	60	33	54	45
Minority interest	0	0	0	0	0	0	0
Net profit	**30**	**-134**	**82**	**184**	**138**	**227**	**190**
Net profit adjusted*	**107**	**-110**	**59**	**162**	**150**	**239**	**202**

*Source: Company data, Santander Brokerage Poland, * excluding IFRS16 impact (2019 onward) and one-offs (2015-18)*

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Fig. 6. PKP Cargo: financials margins / momentum

	2015	2016	2017	2018	2019E	2020E	2021E
EBITDA margin	15.5%	11.1%	14.8%	17.3%	18.5%	19.7%	19.4%
Operating margin	1.2%	-3.0%	3.3%	5.3%	4.7%	6.5%	5.7%
Net profit margin	0.7%	-3.0%	1.7%	3.5%	2.8%	4.2%	3.6%
Sales growth	6.5%	-3.1%	7.4%	10.5%	-4.2%	7.3%	-2.0%
EBITDA growth	39.9%	-30.6%	43.4%	29.2%	2.1%	14.4%	-3.3%
Operating profit growth	-53.8%	-336.2%	-217.4%	79.1%	-14.3%	46.9%	-13.2%
Net profit growth	-61.6%	-544.7%	-161.1%	125.1%	-24.7%	64.1%	-16.5%

Source: Company data, Santander Brokerage Poland

Fig. 7. PKP Cargo: Balance sheet forecasts

PLNmn	2015	2016	2017	2018	2019E	2020E	2021E
Current assets	**1,089.1**	**1,547.9**	**1,694.2**	**1,619.0**	**1,285.5**	**1,363.5**	**1,426.5**
Cash and equivalents	276.2	755.9	516.8	447.3	205.2	219.1	300.5
Other financial assets	4.0	0.9	263.7	203.7	203.7	203.7	203.7
Other non-financial assets	13.3	27.3	35.6	118.7	31.2	33.5	32.9
Inventories	128.5	121.2	148.5	161.6	154.9	166.2	163.0
Trade and other receivables	664.3	639.9	729.5	684.6	687.5	737.8	723.4
Income tax receivables	2.7	2.8	0.1	3.0	2.9	3.1	3.1
Fixed assets	**4,979.5**	**4,942.9**	**4,947.4**	**5,187.2**	**6,246.6**	**6,536.0**	**6,581.2**
PPE	4,719.7	4,700.6	4,688.0	4,946.8	5,995.8	6,274.9	6,323.1
Intangibles	66.4	55.8	43.9	34.6	55.8	55.8	55.8
Investment in affiliates	39.8	40.8	53.6	47.4	47.4	47.4	47.4
Goodwill	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	9.8	8.6	10.5	7.7	7.7	7.7	7.7
Other non-financial assets	39.0	29.5	17.8	15.1	14.5	15.5	15.2
Long-term deferred charges	104.6	107.6	133.6	135.6	125.5	134.6	132.0
Assets for sale	**44.1**	**0.0**	**0.0**	**0.1**	**0.1**	**0.1**	**0.1**
Total assets	**6,112.7**	**6,490.8**	**6,641.6**	**6,806.3**	**7,532.1**	**7,899.5**	**8,007.8**
Current liabilities	**1,172.7**	**1,171.8**	**1,213.1**	**1,353.7**	**1,277.7**	**1,463.7**	**1,432.6**
Bank debt	253.6	197.8	249.7	248.6	236.2	324.4	308.2
Finance lease	65.4	59.6	48.0	21.9	20.8	69.7	66.3
Accounts payable	729.8	670.0	749.7	910.3	877.4	924.3	913.4
Employee benefits	100.4	99.3	104.0	115.5	115.5	115.5	115.5
Other provisions	17.9	25.0	59.7	56.9	27.3	29.3	28.8
Other current liabilities	2.2	118.9	0.3	0.1	0.1	0.1	0.1
Tax liabilites	3.5	1.4	1.6	0.3	0.3	0.3	0.3
Long-term liabilities	**1,586.1**	**2,076.1**	**2,093.7**	**1,969.0**	**2,699.6**	**2,653.9**	**2,603.7**
Bank debt	460.6	1,273.6	1,312.6	1,083.2	1,029.1	977.6	928.7
Finance lease	193.5	140.9	91.1	73.3	862.1	862.1	862.1
Accounts payable	26.0	1.8	1.6	112.0	108.0	113.7	112.4
Provisions for employee benefits	603.6	525.6	558.5	591.4	591.4	591.4	591.4
Other provisions	302.4	134.1	129.9	109.0	109.0	109.0	109.0
Equity	**3,353.9**	**3,242.9**	**3,334.8**	**3,483.7**	**3,554.9**	**3,781.9**	**3,971.5**
Share capital	2,239.3	2,239.3	2,239.3	2,239.3	2,239.3	2,239.3	2,239.3
Share premium	619.4	618.7	619.3	628.2	628.2	628.2	628.2
Other	-2.8	11.4	4.9	-44.0	-44.0	-44.0	-44.0
Retained earnings	497.9	373.4	471.3	660.2	731.4	958.4	1,148.0
Minority Interest	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Total liabilities and equity	**6,112.7**	**6,490.8**	**6,641.6**	**6,806.3**	**7,532.1**	**7,899.5**	**8,007.8**

Source: Company data, Santander Brokerage Poland

Fig. 8. PKP Cargo: Cash flow statement forecasts

PLNmn	2015	2016	2017	2018	2019E	2020E	2021E
Cash flow from operations	**387.5**	**305.5**	**547.0**	**1051.9**	**852.3**	**927.1**	**917.5**
Net profit	30.1	-133.8	81.7	183.9	138.4	227.1	189.6
Provisions	-37.1	-240.4	68.2	20.8	-29.6	2.0	-0.6
Depreciation and amortization	649.0	621.6	546.9	629.4	688.4	710.5	722.0
Changes in WC, o/w	5.9	-52.1	-37.5	302.8	-33.1	-9.0	5.5
inventories	-13.2	7.3	-27.3	-13.2	6.8	-11.3	3.2
receivables	-138.2	24.5	-89.7	44.9	-2.9	-50.2	14.4
payables	157.3	-83.9	79.4	271.0	-37.0	52.6	-12.1
Other, net	-260.4	110.1	-112.3	-84.9	88.2	-3.6	1.0
Cash flow from investments	**-515.2**	**-551.7**	**-561.2**	**-874.9**	**-948.4**	**-998.8**	**-767.6**
Additions to PPE and intangibles	-1358.8	-547.7	-522.4	-879.0	-958.6	-989.7	-770.2
Change in long-term investments	-4.6	-1.0	-12.8	6.2	0.0	0.0	0.0
Other, net	848.2	-3.0	-26.0	-2.1	10.2	-9.2	2.6
Cash flow from financing	**-25.3**	**725.9**	**-224.9**	**-246.6**	**-146.0**	**85.7**	**-68.6**
Change in long-term borrowing	251.4	761.7	-12.7	-244.3	-65.3	-51.5	-48.9
Change in short-term borrowing	99.1	-61.6	40.4	-27.2	-13.5	137.2	-19.7
Change in equity and profit distribution	55.5	22.8	10.2	-35.0	0.0	0.0	0.0
Dividends paid	-110.0	0.0	0.0	0.0	-67.2	0.0	0.0
Other, net	-321.3	3.2	-262.8	59.9	0.0	0.0	0.0
Net change in cash and equivalents	**-153.0**	**479.7**	**-239.1**	**-69.5**	**-242.1**	**13.9**	**81.4**
Beginning cash and equivalents	429.2	276.2	755.9	516.8	447.3	205.2	219.1
Ending cash and equivalents	276.2	755.9	516.8	447.3	205.2	219.1	300.5

Source: Santander Brokerage Poland

Santander Brokerage Poland

Jana Pawla II Avenue 17
00-854 Warszawa
fax. (+48) 22 586 81 09

Equity Research Department

Kamil Stolarski, CFA, *Head of Equity Research* *Strategy, Financials*	tel. (+48) 22 586 81 00	kamil.stolarski@santander.pl
Paweł Puchalski, CFA, *Equity Analyst* *Telecommunications, Metals & Mining, Power*	tel. (+48) 22 586 80 95	pawel.puchalski@santander.pl
Grzegorz Balcerski, *Securities Broker, Investment Advisor* *Equity Analyst, Games, Health Care, Industrials*	tel. (+48) 22 534 16 10	grzegorz.balcerski@santander.pl
Tomasz Krukowski, CFA, *Equity Analyst* *Oil&Gas, CEE Non-Financials*	tel. (+48) 22 586 81 55	tomasz.krukowski@santander.pl
Adrian Kyrcz, *Equity Analyst* *Construction, Real Estate, IT*	tel. (+48) 22 586 81 59	adrian.kyrcz@santander.pl
Tomasz Sokołowski, *Equity Analyst* *Consumer Goods, Retail*	tel. (+48) 22 586 82 36	tomasz.sokolowski@santander.pl
Michał Sopiel, *Equity Analyst* *Industrials, Oil&Gas, Chemicals, Quantitative Analysis*	tel. (+48) 22 586 82 33	michal.sopiel@santander.pl

Sales & Trading Department

Kamil Kalemba, *Head of Institutional Equities*	tel. (+48) 22 586 80 84	kamil.kalemba@santander.pl
Mateusz Choromański, CFA, Head of Sales *Securities Broker, Investment Advisor*	tel. (+48) 22 586 80 82	mateusz.choromanski@santander.pl
Robert Chudala	tel. (+48) 22 586 85 14	robert.chudala@santander.pl
Alex Kamiński	tel. (+48) 22 586 80 63	alex.kaminski@santander.pl
Błażej Leśków, *Securities Broker*	tel. (+48) 22 586 80 83	blazej.leskow@santander.pl
Michał Stępkowski, *Securities Broker*	tel. (+48) 22 586 85 15	michal.stepkowski@santander.pl
Marek Wardzyński, *Securities Broker*	tel. (+48) 22 586 80 87	marek.wardzynski@santander.pl

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Explanations of special terminology used in the recommendation:
EBIT – earnings before interest and tax
EBITDA – earnings before interest, taxes, depreciation, and amortization
P/E – price-earnings ratio
EV – enterprise value (market capitalisation plus net debt)
PEG - P/E to growth ratio
EPS - earnings per share
CPI – consumer price index
WACC - weighted average cost of capital
CAGR – cumulative average annual growth
P/CE – price to cash earnings (net profit plus depreciation and amortisation) ratio
NOPAT – net operational profit after taxation
FCF - free cash flows
BV – book value
ROE – return on equity
P/BV – price-book value

Recommendation definitions:
Buy – indicates a stock's total return to exceed more than 10% over the next twelve months.
Hold - indicates a stock's total return to be in range of 0%-10% over the next twelve months.

Sell - indicates a stock's total return to be less than 0% over the next twelve months.
It is possible for the analyst to indicate different recommendation (buy, sell, hold) than specified in the definition, with a given total expected rate of return on investment, where it is justified due to additional market factors, industry trends, etc. In such case, relevant clarification of the investment recommendation meaning presented in the recommendation is included in the document.

In preparing this document Santander Brokerage Poland applied at least one of the following valuation methods: discounted cash flows (DCF), comparative, mid-cycle, dividend discount model (DDM), residual income, warranted equity method (WEV), SOTP valuation, liquidation value.
The discounted cash flows (DCF) valuation method is based on expected future discounted cash flows. One advantage of the DCF valuation method is that it takes into account all cash streams reaching Issuer and the cost of money over time. Some disadvantages of the DCF valuation method are that a large number of parameters and assumptions need to be estimated; and the valuation is sensitive to changes in those parameters.
The comparative valuation method is based on the economic rule of "one price". Some advantages of the comparative valuation method are that the analyst need only estimate a small number of parameters; the valuation is based on current market conditions; the relatively large accessibility of indicators for companies being compared; and that there is an extensive knowledge of the comparative method among investors. Some disadvantages of valuation by the comparative method are the considerable sensitivity of the results of the valuation on the choice of companies to the comparative group; the method can lead to a simplification of the picture of the company which in turn can lead to omitting certain important factors (e.g. growth dynamics, extra-operational assets, corporate governance, the repeatability of results, differences in applied accounting standards); and the uncertainty of the effectiveness of a market valuation of companies being compared.
The mid-cycle multiple valuation is based on long-term average valuation multiples of a sector or a peer group. The methodology aims to calculate a fair, through the cycle value of the company. Among its shortfalls is that at peaks and/or troughs of the cycle, the implied fair value may deviate substantially from the market's value of an analysed stock as well as the methods' reliance on the quality of external data (we usually use Bloomberg or Damodaran databases). Simplicity and average through-cycle value allowing to capture over- as well as under-valuation of a given stock are the main advantages of this methodology.
The dividend discount model (DDM) valuation is based on the net present value of the future dividends that are expected to be paid out by the company. Some advantages of the DDM valuation method are that it takes into account real cash flows to equity-owners and that the methodology is used in respect to companies with long dividend payout history. Main disadvantage of the DDM valuation method is that dividend payouts are based on a large number of parameters and assumptions, including dividend payout ratio.
Residual income method is conceptually close to the discounted cash flows method (DCF) for non-financial stocks, the difference being that it is based on expected residual income (returns over COE) rather than expected future cash flows. One advantage of this valuation method is that it captures the excess of profit potentially available to shareholders and the cost of money over time. Main disadvantage of the valuation method is that a large number of parameters and assumptions need to be estimated; and the valuation is sensitive to changes in those parameters.
The warranted equity method (WEV) is based on the formula P/BV = (two year forward ROE less sustainable growth rate)/(Cost of equity less sustainable growth rate) which allows estimating a fair value (FV) of a given stock in two years' time. Subsequently the FV is discounted back to today. The main advantage of the WEV method is that it is a transparent one and based on relatively short term forecasts, hence substantially reducing the margin of forecasting error. The main disadvantage in our view is that the model is based on the principle that stock price should converge towards its fair value implied by company's ROE and COE.
SOTP valuation - different assets of a company are being valued according to different valuation methods, and the sum of these valuations represents the final valuation of the company. SOTP valuation advantages / disadvantages are identical to advantages and disadvantages of the specific valuation methods used.
Liquidation value method – liquidation value is the estimated amount of money that an asset or company could be quickly sold for, such as if it were to go out of business. Then, the estimated assets value is adjusted for liabilities and liquidation expenses. One advantage of this valuation method is its simplicity. This method does not account for intangible assets as goodwill, which is the main disadvantage.

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