PKP Cargo (Buy, TP PLN14.2)

Pilot support program for analytical coverage

Bloomberg: PKP PW, Reuters: PKPP.WA

Santander Biuro Maklerskie

CEE Equity Research

Industrials, Poland

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Margins normalization expected

Michał Sopiel, *Equity Analyst*

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

4Q20E results preview

Carriage statistics. We assume that PKP Cargo Group's carriage turnover could come in roughly flat y/y in, while the transport volume may settle almost 2% lower y/y in 4Q20E. In the view of expected change to the transport mix, we anticipate average distance covered to expand slightly y/y in the respective period. Unfortunately the statistics show that PKP Cargo may have under-performed the market in the end of 2020E, though, we point out visibly improving y/y operational indicators in December (though partially attributable to a low base effect). From the segments perspective, we await PKP Cargo to report a further increase of intermodal accompanied by slight rebound of traditional bulk groups.

PKP Cargo: 4Q20E results preview

PLNmn	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20E	y/y	q/q	LTM
Sales	1,164	1,191	1,165	1,036	929	1,010	1,078	-7.5%	6.7%	4,052
EBITDA	192	263	147	90	117	227	158	7.7%	-30.3%	592
EBITDA margin	*16.5%*	*22.1%*	*12.6%*	*8.7%*	*12.6%*	*22.5%*	*14.7%*	*2.1*	*-7.8*	*14.6%*
EBIT	15	81	-39	-106	-76	37	-35	n.a.	n.a.	-180
EBIT margin	*1.3%*	*6.8%*	*-3.4%*	*-10.2%*	*-8.2%*	*3.6%*	*-3.2%*	*n.a.*	*n.a.*	*-4.4%*
Net profit	-5	51	-63	-114	-78	16	-42	n.a.	n.a.	-218
Net margin	*-0.4%*	*4.3%*	*-5.4%*	*-11.0%*	*-8.3%*	*1.5%*	*-3.9%*	*n.a.*	*n.a.*	*-5.4%*
Carriage turnover (bn tkm)	6.6	6.7	6.5	5.8	5.3	6.0	6.5	-0.1%	7.9%	24
Unit revenues	0.176	0.179	0.180	0.178	0.174	0.169	0.167	-7.4%	-1.1%	0.172
y/y dynamic	*5.9%*	*6.6%*	*8.6%*	*1.7%*	*-1.0%*	*-5.6%*	*-7.4%*	*n.a.*	*n.a.*	*-3.2%*
Capex	302	250	230	181	189	164	140	-39.2%	-14.6%	674

Source: Company data, UTK, Santander Brokerage Poland

P&L. Similarly to previous quarter, the forecasted q/q expansion of carriage turnover should be, to some extent, offset by potentially y/y lowered unit revenues (among others due to intensified price competition and contracts' rollout at less appealing rates). Based on our estimates, revenues might amount to PLN1.078bn implying almost +7% q/q or -7.5% change y/y. Despite relatively stable q/q top-line delivery, the operating margins should contract due to lack of government anti-crisis aid (approx. PLN81mn recognised in 3Q20). We expect the Group to maintain its focus on the tight costs management (partially in the view of stretched balance sheet) with particular focus on the labour expenses (estimated at ca. PLN400mn in 4Q20E vs. PLN452mn in the respective period last year). Looking forward, we reckon the aforementioned should stabilize the operational margins performance in 20201E. In the short run, however, our calculations point to EBITDA / EBIT at approx. PLN158mn / PLN-35mn respectively translating into significant q/q fall. Finally, the bottom line could come in red and settle at PLN-42mn. *Summing up, we stress the 4Q20E may be distorted by one-off items related among others to provisions for post-employment benefits, assets value stress tests. In our opinion, however, the net effect of the aforemtnioed could turn neutral or even slightly positive (in the view of the recent scrap metal prices expansion).*

Capex. Calibration of capital outlays with EBITDA should continue in 4Q20E, which may result in further capex q/q decrease to PLN140mn vs. PLN178mn on average in

1-3Q20, we estimate. From the full year perspective, our assumptions show the expenditures should outpace the EBTIDA by approx. PLN80mn.

Cash balance. We expect no major positive surprises in the cash flow statement in October-December 2020E period. EBITDA / capex might turn balanced, while intensified headcount reduction could translate into increase of cash spending. We perceive the net debt / FY20E EBITDA ratio (and indebtedness in general) should remain high. Taking into account recent PKP Cargo's disclosures (regarding the bank covenants thresholds), we await renegotiation of financial agreements in coming months.

Comment: The anti-crisis funds are already a history in case of PKP Cargo, which should translate into normalisation of operational margins in 4Q20E. The rolling stock utilisation may turn below optimal, though, the end of 2020E seems to have brought in some relief to the previously observed negative market trends. We stick to the view there might be some positive business trends observed in both the short and long run. Firstly, the transport volume is rebounding gradually, while the average distance covered remains roughly stable. Secondly, the intensified headcount reduction could translate into more flexible costs base in the longer perspective. Unfortunately, the outlook for durable improvement of free cash flows pattern is still vague. In the short run, it might be associated with the decreasing path of the unit revenues (an effect of the intensified price pressure).

PKP Cargo: financial summary

PLNmn	2015	2016	2017	2018	2019	2020E	2021E	2022E
Sales	4,554	4,411	4,739	5,237	4,866	4,141	4,371	4,458
EBITDA	705	490	702	907	860	597	694	779
EBIT	56	-132	155	278	143	-124	-15	83
Net income	30	-134	82	184	36	-147	-59	20
P/E (x)	32.9	n.a.	43.7	13.3	33.2	n.a.	n.a.	19.5
EV/EBITDA (x)	6.8	6.8	5.8	3.9	5.0	5.7	5.0	4.3
DY	3.1%	0.0%	0.0%	0.0%	4.2%	0.0%	0.0%	0.0%

Source: Company data, Bloomberg, Santander Brokerage Poland

Santander

Santander Brokerage Poland

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

Equity Research

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
Tomasz Krukowski, CFA, *Equity Analyst* *Oil&Gas, Pharma & Biotech, 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, E-commerce, Gaming*	tel. (+48) 22 586 82 36	tomasz.sokolowski@santander.pl
Michał Sopiel, *Equity Analyst* *Industrials, Chemicals, Quantitative Analysis*	tel. (+48) 22 586 82 33	michal.sopiel@santander.pl
Stanisław Czerwiński, *Equity Analyst* *Gaming*	tel. (+48) 22 534 16 10	stanislaw.czerwinski@santander.pl

Sales & Trading

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:
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
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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 pay-out history. Main disadvantage of the DDM valuation method is that dividend pay-outs are based on a large number of parameters and assumptions, including dividend pay-out ratio.
The 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.
The 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.
The 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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