PKP Cargo

Pilot support program for analitycal coverage

Bloomberg: PKP PW, Reuters: PKPP.WA

CEE Equity Research

Industrials, Poland

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Pricing in long run prospects

Recommendation: Hold. 12M TP set at PLN22.9

With this report, we are adopting minor adjustments to our valuation model and updating the peers' valuation component. The aforementioned translates into maintenance of the Hold rating for the stock and 12M TP increase to PLN22.9. We numerate the following risks for PKP Cargo in the mid-run: (1) high financial leverage, (2) market stagnation over recent years followed by significant market share drop, (3) visible competitive pressure and (4) strong labor unions position. Among the positives we point out (1) historical correlations showing that the positive y/y dynamic of railway cargo transport volume used to translate into fares rebound with a ca. 3-4 quarters delay. Additionally, which makes us optimistic in a long run, is the (2) potential for operational leverage decrease and (3) further reduction of headcount regulatory initiatives aimed at unification of market worktime rules in Poland. Weighting all the facts, we stick to cautious approach towards the company. The depth and pace of business restructuring is subject to management discretion and willingness of labor partners to participate in the change.

Volumes recovery impressive only in relative terms. March brought in reversal of the negative y/y operational statistics for PKP Cargo, both in terms of the transport volume and carriage turnover. The momentum swelled in April (ca. 30% y/y change in case of both metrics) translating into encouraging headline figures performance. We point out, however, such an outcome is in a lion's share attributable to a low reference base in 2020 and the entity's carriage structure skewed towards more traditional market segments. For the time being, we maintain the view that despite recent solid y/y dynamics, PKP Cargo may near 2019 carriage volumes / turnover in nominal terms. Said this, the general picture looks less bright. Looking forward, we associate market opportunities with the fiscal stimulus but timing and detailed investment plans are still unknown, which based on the past experience (FY19) makes us conservative about the more dynamic domestic railway cargo market outlook in the mid-run.

Transport fares still under pressure. Paired the assumed relative stagnation of market volumes in historical terms (vs. pre-Covid-19 pandemic levels) with unsupportive contract's rollover last year, we expect the pressure on margins to continue in coming months. Above all, potentially rebounding share or traditional market segment in the sales mix could result in more tuned unit transport fares revival. Historical correlations allow, however, slight optimism as the y/y dynamic of transport volume used to translate into fares rebound with a ca. 3-4 quarters delay. Said this, business environment may improve for PKP at the turn of 2021/22E, according to our current valuation model assumptions, as we believe.

Risks / opportunities. We continue to associate the most significant business risks with the competitive pressure, revival of the wage growth tendencies and the effect curbed financial deleveraging potential. When the opportunities are concerned, we point out potential cyclical market rebound bind to fiscal stimulus and potential revival of the unit fares (already partially factored in our valuation model). What makes us the most optimistic in a long run is the potential for operational leverage reduction, decrease of headcount resulting in operational efficiency improvement and regulatory actions centrally defining locomotive drivers' (as well as other key rail workers) worktime reducing the importance of the labour unions.

Valuation and recommendation. We set target price as the weighted average of DCF (75%) and comparative valuation (25%) at PLN22.9share reflecting the current market valuation. Therefore, we maintain our Hold rating for the stock.

Financial summary*

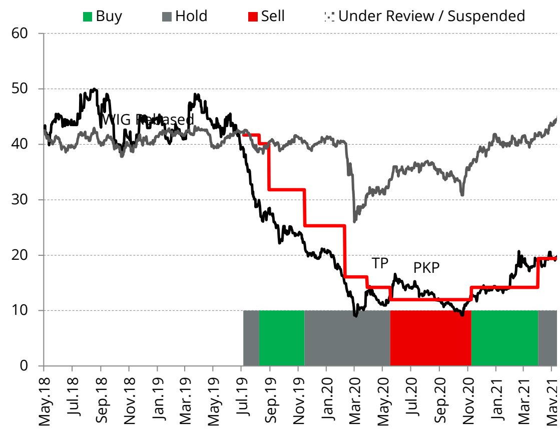
PLNmn	2018	2019	2020	2021E	2022E	2023E
Revenues	5,237	4,866	4,236	4,373	4,601	4,556
EBITDA	907	860	580	719	900	914
EBIT	278	143	-186	-30	171	205
Net profit	184	36	-224	-53	109	139
P/E (x)	13.3	31.3	n.a.	n.a.	8.5	6.8
EV/EBITDA (x)	3.9	4.9	6.1	5.6	4.4	4.1
DY	0.0%	4.5%	0.0%	0.0%	0.0%	0.0%

*Source: Company, Santander Brokerage Poland estimates, *2018-20 ratios based on average historical price*

Recommendation	Hold (maintained)
12M Target Price	PLN22.9
Price (PLN, 10 June 2021)	22.9
Market cap. (PLNmn)	569
Free float (%)	67
Number of shares (mn)	44.8

What has changed:

- Unit fares slightly adjusted upward from 2023rd onward;
- Increased headcount reduction in FY21E;



The chart measures performance against the WIG index.

Main shareholders	% of votes
PKP S.A.	33.01
NN pension fund	15.25
Aviva Santander pension fund	5.22

Source: gpw.pl

Company description

PKP Cargo Group is Poland's largest railway freight service provider. The company delivers logistics solutions and conducts operations in Poland and abroad.

Analyst

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PKP Cargo at a glance

Fig. 1. PKP Cargo: operational and financial data summary

	2017	2018	2019	2020	2021E	2022E	2023E	2024E	2025E
MODELLING ASSUMPTIONS									
Carriage volume (mln t)	119	122	109	94	105	108	105	105	104
Solid fuels	*58*	*57*	*53*	*47*	*48*	*47*	*47*	*46*	*45*
Solid fuels (hard coal)	*51.8*	*51.2*	*47.9*	*42.5*	*41.9*	*41.2*	*40.6*	*39.9*	*39.3*
Aggregates	*22.2*	*26.0*	*20.5*	*17.9*	*21.2*	*22.9*	*20.2*	*19.9*	*19.2*
Metals and ores	*13*	*13*	*9*	*6*	*10*	*11*	*9*	*9*	*9*
Chemical products	*7*	*7*	*6*	*6*	*7*	*7*	*7*	*7*	*7*
Liquid fuels	*5*	*4*	*4*	*2*	*3*	*3*	*3*	*3*	*3*
Timber and agri produce	*4.5*	*4.0*	*3.6*	*2.8*	*3.5*	*3.5*	*3.6*	*3.7*	*3.7*
Intermodal transport	*8*	*9*	*10*	*10*	*11*	*12*	*13*	*14*	*14*
Other	*3*	*3*	*2*	*2*	*2*	*2*	*2*	*2*	*2*
Carriage turnover (bn tkm)	31	31	27	24	26	27	27	27	27
Solid fuels	*12*	*11*	*10*	*9*	*9*	*9*	*9*	*9*	*8*
Solid fuels (hard coal)	*10*	*9*	*9*	*7*	*7*	*7*	*7*	*7*	*7*
Aggregates	*6*	*7*	*5*	*5*	*5*	*6*	*5*	*5*	*5*
Metals and ores	*4*	*4*	*3*	*2*	*3*	*3*	*3*	*3*	*3*
Chemical products	*2*	*2*	*2*	*2*	*2*	*2*	*2*	*2*	*2*
Liquid fuels	*1*	*1*	*1*	*1*	*1*	*1*	*1*	*1*	*1*
Timber and agri produce	*2*	*1*	*1*	*1*	*1*	*1*	*1*	*1*	*1*
Intermodal transport	*3*	*4*	*4*	*4*	*4*	*5*	*5*	*5*	*6*
Other	*1.0*	*0.7*	*0.7*	*0.6*	*0.7*	*0.7*	*0.8*	*0.8*	*0.8*
Average distance (km)	260	258	248	252	251	252	256	257	258
No. of employees (k)	23.3	23.6	23.6	21.8	20.8	20.1	19.4	18.7	18.2
Capex (PLNmn)	562.0	894.1	1,112.7	686.1	639.8	660.0	590.4	588.6	757.5
P&L ACCOUNT ITEMS (PLNmn)									
Revenues	4,739	5,237	4,866	4,236	4,373	4,601	4,556	4,538	4,517
EBITDA	702	907	860	580	719	900	914	911	913
EBIT	155	278	143	-186	-30	171	205	224	236
Net profit	82	184	36	-224	-53	109	139	157	184
BALANCE SHEET ITEMS (PLNmn)									
Cash & equivalents	517	447	550	306	154	157	255	355	293
Total assets	6,642	6,806	7,991	7,559	7,393	7,429	7,473	7,545	7,649
Total bank debt	1,701	1,427	2,623	2,580	2,452	2,370	2,292	2,216	2,143
Total equity	3,335	3,484	3,423	3,144	3,091	3,200	3,338	3,495	3,679
Net debt/cash	921	776	2,072	2,274	2,297	2,213	2,037	1,862	1,850
CF STATEMENT ITEMS (PLNmn)									
Net operating CF	557	1,063	835	546	680	822	840	839	858
CF investing	-573	-884	-1,124	-693	-703	-738	-663	-664	-846
CF financing	-223	-248	393	-97	-129	-81	-78	-76	-73
FCF (after dividends)	-239	-69	103	-244	-152	3	98	99	-62
PERFORMANCE & RETURN									
Op. Profit YoY	-217.4%	79.1%	-48.3%	-230.0%	-83.9%	-667.9%	19.9%	9.6%	5.2%
EPS YoY	-161.1%	125.1%	-80.4%	-723.1%	-76.3%	-305.3%	26.7%	13.0%	17.4%
LEVERAGE AND SOLVENCY									
Net debt/EBITDA (x)	1.3	0.9	2.4	3.9	3.2	2.5	2.2	2.0	2.0
Net debt/ND + Equity	21.6%	18.2%	37.7%	42.0%	42.6%	40.9%	37.9%	34.8%	33.5%
VALUATION MULTIPLES									
P/E (x)	43.7	13.3	31.3	-2.8	-24.9	8.5	6.8	6.1	5.2
EV/EBITDA (x)	5.8	3.9	4.9	6.1	5.6	4.4	4.1	3.9	3.9
Dividend yield	0.0	0.0	4.5	0.0	0.0	0.0	0.0	0.0	0.0
PER SHARE DATA (PLN)									
Reported EPS	1.82	4.11	0.80	-5.01	-1.19	2.44	3.09	3.49	4.10
Adjusted EPS	1.33	3.61	1.07	-4.74	-0.92	2.71	3.36	3.76	4.37
Dividend/share	0.00	0.00	1.50	0.00	0.00	0.00	0.00	0.00	0.00
BVPS	74.46	77.78	76.44	70.20	69.01	71.45	74.54	78.03	82.14

Source: Santander Brokerage Poland estimates, Company, Bloomberg

Valuation

PKP Cargo: DCF valuation

Fig. 2. PKP Cargo: WACC calculation

Risk-free rate	3.0%
Unlevered beta	1.1
Levered beta	1.8
Equity risk premium	5.0%
Cost of equity	**12.2%**
Risk-free rate	3.0%
Debt risk premium	1.5%
Tax rate	19%
After tax cost of debt	**3.6%**
%D	45%
%E	55%
WACC	**8.3%**

Source: Company data, Santander Brokerage Poland estimates

Fig. 3. PKP Cargo: Forecast changes

PLNmn	2021E			2022E			2023E		
	New	Previous	Change	New	Previous	Change	New	Previous	Change
Sales	4,373	4,373	*0%*	4,601	4,601	*0%*	4,556	4,534	*0%*
EBITDA	719	719	*0%*	900	900	*0%*	914	893	*2%*
EBITDA adj.*	601	601	*0%*	782	782	*0%*	796	775	*3%*
EBIT	-30	-30	*n.a.*	171	171	*0%*	205	184	*11%*
Net profit	-53	-53	*n.a.*	109	109	*0%*	139	121	*14%*

*Source: Santander Brokerage Poland estimates, *adj. For IFRS16 impact*

Fig. 4. PKP Cargo: DCF valuation

	2021E	2022E	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
Net sales	**4,373**	**4,601**	**4,556**	**4,538**	**4,517**	**4,532**	**4,559**	**4,587**	**4,615**	**4,643**
EBIT	-30	171	205	224	236	247	282	327	370	403
Cash taxes on EBIT	0	0	0	6	18	20	27	37	45	52
NOPAT	**-30**	**171**	**205**	**218**	**218**	**227**	**254**	**290**	**324**	**352**
Depreciation	749	729	709	687	677	677	669	651	637	628
Change in operating WC	14	16	5	3	2	2	6	8	8	6
Capital expenditure	**640**	**660**	**590**	**589**	**757**	**759**	**567**	**577**	**592**	**615**
Net investment	-95	-54	-113	-95	83	84	-96	-66	-38	-8
Free cash flow	**65**	**224**	**318**	**314**	**135**	**143**	**350**	**356**	**362**	**359**
PV FCF	1,635									
Terminal growth	1.0%									
Terminal Value (TV)	4,665									
PV TV	2,067									
Total EV	**3,702**									
Net debt at (YE20)	2,274									
Minorities	0									
Provisions*	684									
Equity value	**743**									
Month	6									
Current Equity Value	**788**									
Number of shares (mn)	44.8									
Value per share (PLN)	**17.6**									
12M Target Price (PLN)	**19.7**									

*Source: Santander Brokerage Poland estimates, *attributable chiefly to post-employment benefits*

PKP Cargo: Comparable valuation

Fig. 5. PKP Cargo: Comparable valuation (PLN)

	P/E (x)			EV/EBITDA (x)		
	2021E	2022E	2023E	2021E	2022E	2023E
DM peers	n.a.	n.a.	56.2	164.8	198.5	189.6
EM peers	n.a.	n.a.	25.9	30.3	44.5	40.5

Source: Bloomberg, Santander Brokerage Poland estimates

Fig. 6. PKP Cargo: Comparable valuation – segment average (PLN)

	Weight	P/E (x) 2021-23E	EV/EBITDA (x) 2021-23E	Average 2021-23E
DM peers	0%	56.23	184.27	120.25
EM peers	100%	25.95	38.44	32.19
Weighted average	**100%**	**25.95**	**38.44**	**32.19**

Source: Bloomberg, Santander Brokerage Poland estimates

In the peers' valuation, we focus on the EM entities as we reckon their business models and business environment better reflects PKP Cargo's current operational reality.

Fig. 7. PKP Cargo: per share valuation (PLN)

	New	Previous	*Change*
DCF valuation	19.7	15.0	32%
Comparable valuation (based on 2021-23E)*	32.2	32.5	-1%
Weighted average (DCF: 75%; CV: 25%)	**22.9**	**19.4**	**18%**

*Source: Santander Brokerage Poland estimates, *rounded values*

Based on our DCF-model derived valuation pointing at PLN19.7 per share (a 75% weight) and peers valuation indicating PLN32.2 value per share (a 25% weight), we set a 12M TP at PLN22.9. We attribute higher weight to the DCF method as the one reflecting long-run character and expressing company's potential to manage its indebtedness.

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Financial summary

Fig. 8. PKP Cargo: Income statement forecasts

PLNmn	2017	2018	2019	2020	2021E	2022E	2023E
Operating revenue	**4,739**	**5,237**	**4,866**	**4,236**	**4,373**	**4,601**	**4,556**
Operating expenses	**4,584**	**4,960**	**4,722**	**4,422**	**4,403**	**4,430**	**4,352**
Depreciation	547	629	717	767	749	729	709
Raw materials & supplies	706	781	748	625	660	680	659
External services	1,573	1,725	1,345	1,224	1,239	1,278	1,252
Employee benefits	1,509	1,651	1,737	1,638	1,598	1,579	1,569
Other operating expenses	248	174	176	169	158	164	163
EBITDA	**702**	**907**	**860**	**580**	**719**	**900**	**914**
EBITDA adjusted*	**702**	**907**	**742**	**462**	**601**	**782**	**796**
Operating profit	**155**	**278**	**143**	**-186**	**-30**	**171**	**205**
Operating profit adjusted*	**128**	**250**	**126**	**-203**	**-47**	**154**	**188**
Net financials	**-39**	**-42**	**-72**	**-82**	**-65**	**-65**	**-63**
Financial revenue	20	16	8	2	7	7	7
Financial expenses	60	58	79	85	73	72	70
Share in the profit of associates	1	4	2	2	2	2	2
One-off items	0	4	0	0	0	0	0
PBT	**116**	**244**	**74**	**-267**	**-94**	**107**	**143**
PBT adjusted*	**89**	**216**	**57**	**-284**	**-111**	**90**	**126**
Income tax	35	60	38	-43	-41	-2	4
Minority interest	0	0	0	0	0	0	0
Net profit	**82**	**184**	**36**	**-224**	**-53**	**109**	**139**
Net profit adjusted*	**59**	**162**	**48**	**-212**	**-41**	**121**	**151**

*Source: Company, Santander Brokerage Poland estimates, * excluding IFRS16 impact (2019 onward) and one-offs (2017-18)*

Fig. 9. PKP Cargo: financials margins / momentum

	2017	2018	2019	2020	2021E	2022E	2023E
EBITDA margin	15%	17%	18%	14%	16%	20%	20%
Operating margin	3%	5%	3%	-4%	-1%	4%	4%
Net profit margin	2%	4%	1%	-5%	-1%	2%	3%
Sales growth	7%	11%	-7%	-13%	3%	5%	-1%
EBITDA growth	43%	29%	-5%	-33%	24%	25%	2%

Source: Company, Santander Brokerage Poland estimates

Fig. 10. SANe forecasts vs. consensus

PLNmn	2021E			2022E			2023E		
	SANe	Cons	Dev.	SANe	Cons	Dev.	SANe	Cons	Dev.
Sales	4,373	4,311	*1%*	4,508	4,474	*1%*	4,556	4,650	*-2%*
EBITDA	719	696	*3%*	900	839	*7%*	914	874	*5%*
EBIT	-30	-62	*n.a.*	171	91	*n.a.*	205	170	*20%*
Net profit	-53	-104	*n.a.*	109	13	*n.a.*	139	73	*91%*

Source: Bloomberg, Santander Brokerage Poland estimates

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Fig. 11. PKP Cargo: Balance sheet forecasts

PLNmn	2017	2018	2019	2020	2021E	2022E	2023E
Current assets	**1,694**	**1,619**	**1,488**	**1,149**	**1,028**	**1,053**	**1,143**
Cash and equivalents	517	447	550	306	154	157	255
Other financial assets	264	204	0	0	0	0	0
Other non-financial assets	36	119	133	88	109	115	114
Inventories	148	162	161	166	171	180	178
Trade and other receivables	730	685	592	587	590	598	592
Income tax receivables	0	3	51	3	3	3	3
Fixed assets	**4,947**	**5,187**	**6,504**	**6,397**	**6,352**	**6,363**	**6,317**
PPE	4,688	4,947	5,202	5,121	5101	5117	5081
Right-of-use assets	0	0	1,079	1,009	976	960	952
Investment in affiliates	54	47	40	42	42	42	42
Goodwill	0	0	3	3	3	3	3
Other financial assets	2	1	11	10	10	10	10
Other non-financial assets	70	57	55	35	36	38	38
Long-term deferred charges	134	136	114	178	184	193	191
Assets for sale	**0**	**0**	**0**	**13**	**13**	**13**	**13**
Total assets	**6,642**	**6,806**	**7,991**	**7,559**	**7,393**	**7,429**	**7,473**
Current liabilities	**1,213**	**1,354**	**1,452**	**1,386**	**1,304**	**1,292**	**1,260**
Bank debt	298	271	421	479	380	361	343
Accounts payable	752	911	858	767	764	769	755
Employee benefits	104	116	127	116	116	116	116
Other provisions	60	57	46	24	44	46	46
Long-term liabilities	**2,094**	**1,969**	**3,116**	**3,030**	**2,998**	**2,937**	**2,874**
Bank debt	1,404	1,157	2,201	2,102	2071	2009	1949
Accounts payable	2	112	157	146	145	146	143
Provisions for employee benefits	559	591	657	684	684	684	684
Other provisions	130	109	100	98	98	98	98
Equity	**3,335**	**3,484**	**3,423**	**3,144**	**3,091**	**3,200**	**3,338**
Share capital	2,239	2,239	2,239	2,239	2,239	2,239	2,239
Share premium	619	628	781	782	782	782	782
Other	416	540	0	-55	-55	-55	-55
Retained earnings	60	76	403	178	124	234	372
Minority Interest	0	0	0	0	0	0	0
Total liabilities and equity	**6,642**	**6,806**	**7,991**	**7,559**	**7,393**	**7,429**	**7,473**

Source: Company, Santander Brokerage Poland estimates

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Fig. 12. PKP Cargo: Cash flow statement forecasts

PLNmn	2017	2018	2019	2020	2021E	2022E	2023E
Cash flow from operations	**557**	**1063**	**835**	**546**	**680**	**822**	**840**
Net profit	82	184	36	-224	-53	109	139
Provisions	68	21	57	-8	20	2	0
Depreciation and amortization	547	629	717	767	749	729	709
Changes in WC, o/w	-156	301	86	-102	-13	-11	-9
inventories	-27	-13	1	-5	-5	-9	2
receivables	-90	45	93	6	-4	-8	6
payables	-39	270	-8	-102	-4	5	-16
Other, net	16	-72	-61	113	-22	-8	1
Cash flow from investments	**-573**	**-884**	**-1124**	**-693**	**-703**	**-738**	**-663**
Additions to PPE and intangibles	-534	-888	-1150	-628	-697	-729	-665
Change in long-term investments	-13	6	7	-2	0	0	0
Other, net	-26	-2	19	-64	-6	-10	2
Cash flow from financing	**-223**	**-248**	**393**	**-97**	**-129**	**-81**	**-78**
Change in long-term borrowing	-10	-246	135	-99	-31	-62	-60
Change in short-term borrowing	40	-27	151	57	-98	-19	-18
Change in equity and profit distribution	10	-35	-29	-55	0	0	0
Dividends paid	0	0	-67	0	0	0	0
Other, net	-263	60	204	0	0	0	0
Net change in cash and equivalents	**-239**	**-69**	**103**	**-244**	**-152**	**3**	**98**
Beginning cash and equivalents	756	517	447	550	306	154	157
Ending cash and equivalents	517	447	550	306	154	157	255

Source: Santander Brokerage Poland estimates

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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
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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.
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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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