PKN Orlen

Santander Biuro Maklerskie

Bloomberg: PKN WA, Reuters: PKN.WA

CEE Equity Research

Oil & Gas, Poland

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Cheap, but others offer more

Downgrading to Neutral, TP upped to PLN67 from PLN65

PKN's valuation multiples (2023E P/E of 4x and EV/EBITDA of 2x) look very appealing, but we believe that they just reflect peak-cycle profitability. Moreover, PKN is trading broadly in line with its peer group of mid-sized integrated oil & gas companies. We also note that PKN, unlike its peer group, channels extraordinary profitability earned in 2022-23E into new capex projects. Therefore it offers the lowest FCF yield and the lowest dividend yield, while we believe they are the most important metrics now. We are downgrading PKN to Neutral from Outperform. We see better value in other CEE Oil & Gas companies (OMV, MOL). We have increased our target price to PLN67 from PLN65 on minor tweaks in earnings forecasts and valuation model.

3Q23 was record high. Clean EBITDA of PLN11.8bn was record high, even if we adjust it for PLN2.3bn impact of Lotos consolidation. The earnings included PLN0.9bn gain on the hedging of refining margin, but we treat it as a recurring item. Segment-wise, again it was the quarter of the refining (LIFO EBITDA of PLN8.0bn, including PLN1.7bn of Lotos consolidation) which reaped the benefits of strong macro. We also estimate that Urals processing added PLN1.7bn to earnings (gain on differential). PKN ended the quarter with net debt of PLN11.6bn.

Earnings forecasts. We assumed nat gas price regulations in Poland are likely to cost PKN c. PLN15bn in 2023E. We expect a zero result on gas trading (we believe only a fraction of LNG supplies in 2023E is likely to be priced at HH) and we assume a PLN15bn tax on domestic gas production. Our macro assumptions are: nat gas price of EUR125/MWh and EUR100/MWh in 2023-24E as well as refining macro normalisation from 2Q 2023E (end of heating season to drive normalisation in middle distillates). Our base-case assumptions imply PKN's net profit of PLN19bn and PLN14bn in 2024E (we focus on net profit rather than EBITDA due to high taxation in upstream).

Strategy update is due shortly: PKN is about to present its updated strategy, including new dividend policy at the turn of the year. We stick to our view that dividend is likely to be cut from PLN3.5/share to PLN3.0/share owing to rising capex: in 2022 the company plans to spend PLN17.6bn, including Lotos. We forecast capex of PLN27bn in 2023E with the growth being driven mostly by consolidation of PGNiG (PLN8bn) and additional spending on petchems and energy (CCGTs). We forecast PKN's FCF (pre-dividends) at PLN5.1bn in 2023E, yielding 7.0%. The latter appears bleak if compared to double-digit FCF yields of OMV or MOL.

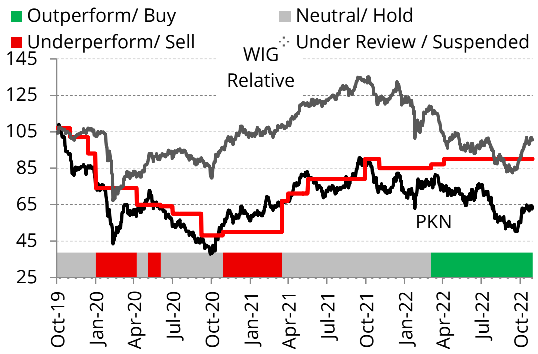
Valuation and risks. Our target price of PLN67 (inched up from PLN65) is based on DCF and comparative valuation with 50/50 weights. Key risks include the industry macro backdrop (oil prices, nat gas prices, refining and petchem margins, FX) and regulatory environment (windfall levies, energy and nat gas prices regulations, management appointment).

PKN: Financial summary and ratios (year to December)

PLNmn	2019	2020	2021	2022E	2023E	2024E
Revenues	111,203	86,178	131,341	244,914	385,871	344,957
EBITDA LIFO*	9,172	8,348	14,151	34,036	50,073	41,538
EBITDA	8,862	8,445	19,211	39,962	50,073	41,538
Net profit	4,300	2,755	11,122	24,898	18,962	13,679
P/E (x)	9.7	9.2	2.8	1.5	3.8	5.3
EV/ EBITDA LIFO* (x)	5.2	5.3	3.5	1.6	1.7	2.1
FCF Yield (%)	11.2%	-9.1%	9.2%	33.0%	7.0%	5.5%
Dividend Yield (%)	3.6%	1.7%	4.8%	5.6%	4.8%	4.8%

*Source: Company data, Santander Brokerage Poland estimates *NOTE: pre impairments*
Historical 2019-21 valuation ratios based on historical average prices

Recommendation	**Neutral**
Target Price (Dec'23 PLN)	**67**
Price (PLN, 28 November 2022)	62.6
Market cap*(PLNbn)	72.6
Free float	50%
Number of share (mn)	1,161



The chart measures performance against the WIG index.

Main shareholders*	**% of votes**
Polish state	50.0

*Source: Company data *NOTE: based on fully diluted number of shares, after merger with PGNiG*

Company description

PKN Orlen is an integrated oil & gas company.

Analyst

Tomasz Krukowski, CFA, *Equity Analyst*

+48 22 586 81 55 tomasz.krukowski@santander.pl

Fig. 1. PKN: Ratios, assumptions and forecasts

Key ratios	2018	2019	2020	2021	2022E	2023E	2024E	2025E
EPS (PLN)	12.99	10.05	6.44	26.00	41.53	16.33	11.78	13.05
DPS (PLN)	3.00	3.50	1.00	3.50	3.50	3.00	3.00	3.00
BVPS (PLN)	83.5	90.2	97.3	120.9	237.9	136.2	145.0	155.0
Average number of shares (mn)	428	428	428	428	600	1,161	1,161	1,161
MCAP (PLNmn)	40,560	41,661	25,234	31,034	37,535	72,673	72,673	72,673
EV (PLNmn)	46,171	48,118	44,351	49,735	53,475	86,501	85,403	70,277
P/E (x)	7.30	9.69	9.16	2.79	1.5	3.8	5.3	4.8
P/BV (x)	1.1	1.1	0.6	0.6	0.3	0.5	0.4	0.4
Dividend Yield (%)	3.2%	3.6%	1.7%	4.8%	5.6%	4.8%	4.8%	4.8%
FCF yield (x)	-7.5%	11.2%	-9.1%	9.2%	33.0%	7.0%	5.5%	24.8%
EV/Clean EBITDA (x)	5.5	5.2	5.3	3.5	1.6	1.7	2.1	1.8

Assumptions	2018	2019	2020	2021	2022E	2023E	2024E	2025E
Brent (USD/bbl)	70.4	64.0	42.0	71.0	101.7	82.0	72.0	65.0
NCG gas price (EUR/MWh, rhs)	22.8	14.0	9.5	40.1	124.5	125.0	100.0	50.0
Effective refining margin (USD/bbl)	NA	2.9	-0.2	2.6	5.6	4.6	3.9	4.2
Benchmark petchem margin (EUR/tl)	887	859	839	1,273	1,194	1,050	1,050	1,000
USDPLN FX rate	3.61	3.84	3.90	3.86	4.49	4.38	4.38	4.38
Upstream output (consolidated, kbpd)	18	18	18	17	43	179	187	190
Downstream throughput (kbpd)	677	687	598	607	737	818	818	818

P&L extracts (PLNmn)	2018	2019	2020	2021	2022E	2023E	2024E	2025E
Sales	109,706	111,203	86,178	131,341	244,914	385,871	344,957	263,345
EBITDA	9,888	8,862	8,445	19,211	39,962	50,073	41,538	39,955
EBITDA LIFO (clean)	8,324	9,172	8,348	14,151	34,036	50,073	41,538	39,955
Downstream	6,031	6,667	5,218	11,589	27,701	16,598	13,162	14,289
Retail	2,781	3,045	3,232	2,897	2,625	2,891	3,083	3,176
Upstream	305	295	322	387	5,908	28,781	37,674	19,188
Gas Trading and Storage	0	0	0	0	-1,350	-202	-14,455	1,158
Gas Distribution	0	0	0	0	348	2,454	2,504	2,547
CHP Generation	0	0	0	0	211	1,152	1,187	1,223
Other/ corporate	-793	-835	-424	-722	-1,407	-1,600	-1,618	-1,625
EBIT	7,215	5,365	3,908	13,870	32,951	36,573	26,934	23,822
Pre-tax profit	7,110	5,352	2,856	13,683	31,609	35,745	25,959	23,040
Tax	1,506	1,054	31	2,495	6,423	16,584	12,180	7,788
Minorities	48	-2	70	83	288	200	100	100
Net profit	5,556	4,300	2,755	11,122	24,898	18,962	13,679	15,152

BS extracts (PLNmn)	2018	2019	2020	2021	2022E	2023E	2023E	2023E
Total Assets	64,141	71,202	83,827	106,754	279,354	294,692	300,340	304,313
Equity	35,727	38,596	41,596	51,707	142,616	158,095	168,291	179,960
Minorities	12	11	783	871	1,159	1,359	1,459	1,559
Net debt	5,599	6,446	18,334	17,830	14,781	12,469	11,271	-3,955
Net debt to EBITDA LIFO (x)	0.7	0.7	2.2	1.3	0.4	0.2	0.3	-0.1
Net debt to Equity	16%	17%	44%	34%	10%	8%	7%	-2%

Cash flow (PLNmn)	2018	2019	2020	2021	2022E	2023E	2024E	2025E
Operating CF	4,980	8,663	6,572	12,594	20,981	32,020	32,990	42,477
Investing CF	-8,020	-3,994	-8,868	-9,739	-8,600	-26,925	-29,009	-24,467
FCF pre dividends	-3,040	4,669	-2,296	2,855	12,381	5,095	3,981	18,009
Dividends paid	-1,284	-1,497	-428	-1,498	-2,193	-3,483	-3,483	-3,483

Source: Company data, Santander Brokerage Poland estimates NOTE: Historical 2018-21 valuation ratios based on historical average prices

Fig. 2. PKN: Quarterly earnings and forecasts

Assumptions	1Q21	2Q21	3Q21	4Q21	2021	1Q22	2Q22	3Q22	y/y	q/q
Brent (USD/bbl)	61.0	69.0	74.0	80.0	71.0	102.0	112.9	101.0	*36%*	*-11%*
Ref. margin, Brent-based (USD/bbl)	0.5	1.5	3.1	4.5	2.4	6.0	26.5	16.4	*429%*	*-38%*
Effective ref. margin (USD/bbl)	-1.9	0.0	4.2	6.2	2.6	5.9	19.8	21.4	*408%*	*8%*
Petchem margin (EUR/t)	1,044	1,473	1,318	1,253	1,273	1,166	1,405	1,155	*-12%*	*-18%*
USDPLN FX rate	3.78	3.76	3.87	4.04	3.86	4.13	4.36	4.71	*22%*	*8%*
Upstream output (kbpd)	16	18	17	16	17	16	19	27	*60%*	*47%*
Downstream throughput (kbpd)	513	554	669	688	607	671	583	845	*26%*	*45%*

P&L extracts (PLNmn)	1Q21	2Q21	3Q21	4Q21	2021	1Q22	2Q22	3Q22	y/y	q/q
Revenues	24,562	29,423	36,442	41,165	131,341	45,447	57,804	72,996	*100%*	*26%*
EBITDA	3,524	4,084	5,153	5,470	19,211	4,933	6,665	16,996	*230%*	*155%*
EBITDA LIFO, of which	2,425	3,167	4,266	4,293	14,151	2,786	8,204	11,679	*174%*	*42%*
Upstream	14	60	130	183	387	162	336	842	*548%*	*151%*
Downstream	2,153	2,514	3,220	3,702	11,589	2,355	7,475	10,294	*220%*	*38%*
Refining	*22*	*278*	*1,165*	*2,149*	*3,614*	*900*	*4,656*	*7,998*	*587%*	*72%*
Petchem	*872*	*1,021*	*1,013*	*1,389*	*4,295*	*451*	*1,643*	*689*	*-32%*	*-58%*
Energy	*1,259*	*1,215*	*1,042*	*164*	*3,680*	*1,004*	*1,176*	*1,607*	*54%*	*37%*
Retail	548	828	948	573	2,897	585	697	865	*-9%*	*24%*
Other	-290	-235	-32	-165	-722	-316	-304	-322	*NM*	*NM*
EBIT	2,232	2,771	3,825	3,973	13,870	3,533	5,218	15,478	*305%*	*197%*
Net profit	1,846	2,226	2,909	3,177	11,122	2,770	3,612	12,677	*336%*	*251%*

EBITDA adjustments	1Q21	2Q21	3Q21	4Q21	2021	1Q22	2Q22	3Q22	y/y	q/q
Reported EBITDA	3,524	4,084	5,153	5,470	19,211	4,933	6,665	16,996	*230%*	*155%*
LIFO effect	1,142	963	890	1,251	4,246	2,174	1,321	-553	*NM*	*NM*
Impairments/ write-ups	-43	-46	-3	-74	-166	-27	-2,860	5,870	*NM*	*NM*
Inventory revaluation to NRV	193	14	3	3	213	0	0	0	*NM*	*NM*
Insurance compensations/ Other	532	764	675	1,684	3,655	-1,725	65	-131	*NM*	*NM*
Clean EBITDA estimate, of which	**1,700**	**2,389**	**3,588**	**2,606**	**10,283**	**4,511**	**8,139**	**11,810**	***229%***	***45%***
Upstream	*14*	*60*	*130*	*183*	*387*	*162*	*336*	*842*	*548%*	*151%*
Refining	*-328*	*3*	*1,005*	*1,582*	*2,262*	*1,472*	*4,632*	*8,203*	*716%*	*77%*
Petchem	*659*	*734*	*878*	*796*	*3,067*	*1,065*	*1,620*	*773*	*-12%*	*-52%*
Energy	*1,097*	*998*	*845*	*-360*	*2,580*	*1,547*	*1,155*	*1,479*	*75%*	*28%*
Retail	*548*	*828*	*948*	*573*	*2,897*	*585*	*697*	*865*	*-9%*	*24%*
Other	*-290*	*-234*	*-218*	*-168*	*-910*	*-320*	*-301*	*-352*	*NM*	*NM*

Cash flow extracts (PLNmn)	1Q21	2Q21	3Q21	4Q21	2021	1Q22	2Q22	3Q22	y/y	q/q
EBITDA, as reported	3,524	4,084	5,153	5,470	19,211	4,933	6,665	16,996	*230%*	*155%*
Operating CF	3,858	5,117	4,286	119	13,295	1,803	8,952	8,978	*109%*	*0%*
Investing CF	-3,746	-2,879	-2,204	-965	-9,739	-4,655	-4,581	-467	*NM*	*NM*
FCF pre-dividends	112	2,238	2,082	-846	3,556	-2,852	4,371	8,511	*309%*	*95%*

Source: Company data, Santander Brokerage Poland estimates

Fig. 3. PKN: Earnings revisions

	2022E			2023E			2024E		
	NEW	OLD	*ch.*	NEW	OLD	*ch.*	NEW	OLD	*ch.*
Brent (USD/bbl)	**101.7**	99.8	*2%*	**82.0**	77.0	*6%*	**72.0**	67.0	*7%*
PKN's effective margin	**15.7**	14.3	*10%*	**6.3**	*475%*	*32%*	**3.8**	*375%*	*0%*
LIFO EBITDA (USDmn)	**6,960**	6,660	*5%*	**5,029**	4,489	*12%*	**4,094**	4,034	*1%*
LIFO EBITDA (PLNmn)	**34,036**	32,660	*4%*	**50,073**	48,102	*4%*	**41,538**	41,306	*1%*
EBITDA (PLNmn)	**39,962**	35,270	*13%*	**50,073**	48,102	*4%*	**41,538**	41,306	*1%*
Net profit (PLNmn)	**24,898**	19,827	*26%*	**18,962**	18,079	*5%*	**13,679**	13,032	*5%*

Source: Santander Brokerage Poland estimates

Valuation

We have inched up our target price to PLN67 from PLN65. Our target price is based on DCF and comparative valuation with 50%/50% weights.

Fig. 4. PKN: Valuation summary

Method	Value (PLN)	Weight
DCF	74.9	50%
Comparative valuation	60.0	50%
Target price* (PLN)	**67**	

*Source: Santander Brokerage Poland estimates *NOTE: rounded to the nearest whole number*

DCF

We value PKN using DCF at PLN74.9/share. We use two stage WACC of 13.0% for 2023-25E (based on CAPM with 7% RFR, ERP of 6.0% and market beta of 1.2) and of 11.0% from 2026E onwards (RFR of 5%, other parameters unchanged). We have increased our RFR assumptions by 100bps to make them in line with the rest of our coverage universe. We use a terminal growth rate of 1%.

Fig. 5. PKN: DCF summary

	2023E	2024E	2025E	2026E	2027E	2028E	LT
Brent (USD/bbl)	82.0	72.0	65.0	61.0	60.0	60.0	60.0
Nat gas (EUR/MWh)	125.0	100.0	50.0	25.0	25.0	25.0	25.0
Effective refining margin (USD/bbl)	6.3	3.8	3.8	3.8	3.8	3.8	3.8
USDPLN FX rate	4.38	4.38	4.38	4.38	4.38	4.38	4.38
USDEUR FX rate	4.60	4.60	4.60	4.60	4.60	4.60	4.60
EBITDA (PLNmn)	50,073	41,538	39,955	31,772	32,478	32,781	33,091
NOPAT (PLNmn)	20,517	15,009	16,271	11,362	11,707	11,765	11,847
D&A (PLNmn)	13,500	14,604	16,132	17,014	17,434	17,661	17,863
Capex (PLNmn)	26,925	29,009	24,467	20,967	19,547	19,547	19,547
Change in WC (PLNmn)	58	5,307	11,792	6,136	-35	-152	-157
FCF (PLNmn)	7,150	5,911	19,729	13,544	9,559	9,727	10,007

Source: Santander Brokerage Poland estimates

Comparative valuation

We have abandoned our valuation based on historical P/E and EV/EBITDA trading multiples due to significant de-rating of the sector in recent quarters, seemingly peak-cycle profitability in 2022-24E as well as high uncertainty as to the market and regulatory environment. We believe that the valuation based on cash payments to shareholders i.e. dividend yield, is the most relevant now. In the past 10 years, the average dividend yield in the sector was at 5%. We decided to use this multiple, acknowledging that in the environment of high risk free rates some may require higher returns. We forecast PKN to pay DPS of PLN3/share in 2023-24E, which implies the value of PLN60/share.

Fig. 6. PKN: Valuation using target multiple

	2023E	2024E	Average
Target dividend yield	5.0%	5.0%	
DPS (PLN)	3.00	3.00	
Implied price (PLN)	**60**	**60**	**60**

Source: Company data, Bloomberg, Santander Brokerage Poland estimates

Santander Brokerage Poland

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

Equity Research

Kamil Stolarski, PhD, CFA, *Head of Equity Research* *Banks, Insurers, Strategy*	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*	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
Piotr Zielonka, CFA, *Equity Analyst* *Gaming, Strategy*	tel. (+48) 22 534 16 10	piotr.zielonka@santander.pl
Marcin Działek, *Analyst* *Technical Analysis*	tel. (+48) 22 782 93 09	marcin.dzialek@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
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
Adam Mizera, *ACCA, CFA, Securities Broker*	tel. (+48) 22 586 85 14	adam.mizera@santander.pl

Santander

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Outperform – Total return 10% above benchmark. Upside of approximately ≥15%.
Neutral - Total return 0%-10% above benchmark. Upside of approximately 5%-15%.
Underperform - Total return below benchmark. Upside of approximately <5%.
NOTE: The relevant benchmark for European Equities (including CEE Equities) is the 1Y German Bund rate +ERP (5.5%).

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In preparing this report 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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