

5 May 2010

KGHM

Reuters: **KGHM.WA** Bloomberg: **KGH PW** Exchange: **WSE** Ticker: **KGHM**

Development project announced

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Foreign expansion unlikely to affect nearest dividend payment

The first details of KGHM's expansion project look reasonable. Short-term cash spending is low (maximum USD77m, less than one-month operating cash flow), while the total project capex of USD535m is likely to be incurred towards 2012-13. As such, the impact on the upcoming dividend payment should be small (we forecast PLN10/share). The agreement's structure (KGHM injects money to JV with the option to acquire an additional stake), as well as the project's economics (cash costs of USD2,000/t), also look inviting, despite execution risks.

Structure of the deal looks reasonable...

KGHM is to acquire 1) a 10% stake in Abacus (an exploration company) for USD4.5m, 2) 51% in a JV to which Abacus inserts the rights to the Afton-Ajax project, while KGHM commits USD37m in cash, 3) an option for an additional 29% interest in the JV for a maximum of USD35m. The option may be exercised upon the completion of Ajax's bankable feasibility study with a valuation of USD0.025 per pound of corresponding 29% of P&P copper equivalent reserves. The timing of the option execution is not yet set, but we believe it will be end-2010/2011.

...as do the initial estimates of the project's economics

According to the preliminary economic assessment published by Abacus, Ajax is an open pit mine project with measured and indicated resources of 1.3mt of copper and 2.7m oz of gold. The annual production should reach ca. 50kt of copper and 100k oz of gold, with a mine lifespan of 23 years. The production start-up is scheduled for 2014-15, following capex of USD535m (KGHM is obliged to secure financing). Estimated cash costs are at USD2,000/t copper. Assuming copper prices of USD5,500/t and a gold price of USD900/oz, Abacus indicated a payback period of three years. The project is located in British Columbia, Canada.

Valuation and risks

We value KGHM using SOTP to arrive at a PLN115 target price (ex-dividends, which we expect at PLN10/sh), based on telecom assets (PLN20), the copper business (PLN86) and net cash as of end-2010 (PLN9). The main downside risks are lower-than-expected copper prices and a stronger-than expected PLN vs. USD rate. See p. 5.

Forecasts and ratios

Year End Dec 31	2008A	2009A	2010E	2011E
Revenue (PLNm)	11,303	11,061	12,370	14,166
EBITDA (PLNm)	4,078	3,646	4,460	5,993
Net Earnings (PLNm)	2,920	2,540	3,194	4,443
DB EPS (PLN)	14.60	12.70	15.97	22.21
P/E (DB EPS) (x)	5.3	5.7	6.6	4.7
EV/EBITDA (x)	2.4	2.6	3.4	2.3
DPS (PLN)	11.68	10.16	12.78	17.77
Yield (%)	15.0	14.0	12.2	16.9

Source: Deutsche Bank estimates, company data

Deutsche Bank AG/London

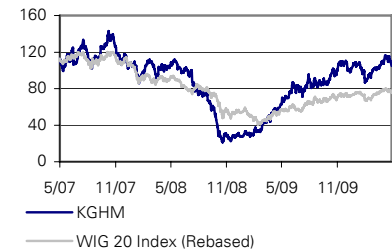
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Breaking News

Buy

Price at 4 May 2010 (PLN)	105.00
Price Target (PLN)	115.00
52-week range (PLN)	116.10 - 62.75

Price/price relative



Performance (%)	1m	3m	12m
Absolute	-4.1	14.1	66.7
WIG 20 Index	-3.9	7.3	30.8

Stock data

Market Cap (PLNm)	21,000.0
Market Cap (US\$m)	6,844.2
Free float (%)	68
WIG 20 Index	2,452.7

Key indicators (FY1)

ROE (%)	29.1
ROA (%)	21.8
Net debt/equity (x)	-15.6
Book value/share (PLN)	57.8
Price/book (x)	1.8
Net interest cover (x)	-
EBIT margin (%)	31.4

Model updated:09 April 2010

Running the numbers**Emerging Europe****Poland****Metals & Mining****KGHM**

Reuters: KGHM.WA

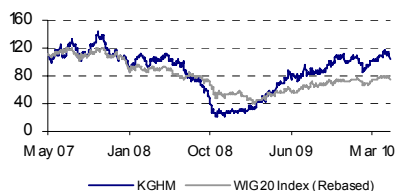
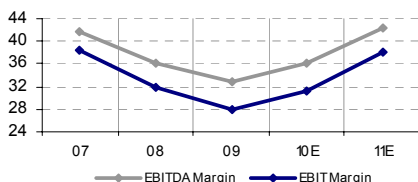
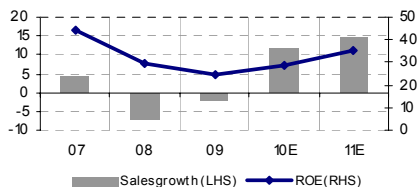
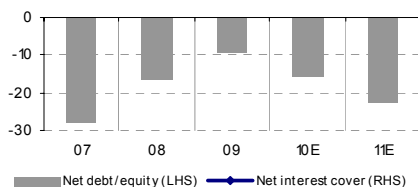
Bloomberg: KGH PW

Buy

Price (4 May 10)	PLN 105.00
Target price	PLN 115.00
52-week Range	PLN 62.75 - 116.10
Market Cap (m)	PLNm 21,000 USDm 6,844

Company Profile

KGHM is a fully integrated copper and silver producer. The company operates three deep underground mines (600-1500m), three smelters and one rolling mill. KGHM, the sixth largest producer of electrorefined copper in the world mines around 550kt of copper per year. Proven copper deposits amount to 33.5mt, which covers more than 20 years of production at current levels of output. KGHM has been investing in telecoms ventures. It holds a stake in mobile operator Polkomtel (19%), and 100% in alternative carrier - Dialog Telephony.

Price Performance**Margin Trends****Growth & Profitability****Solvency**

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Fiscal year end 31-Dec

Financial Summary

	2007	2008	2009	2010E	2011E
DB EPS (PLN)	18.99	14.60	12.70	15.97	22.21
Reported EPS (PLN)	18.99	14.60	12.70	15.97	22.21
DPS (PLN)	9.00	11.68	10.16	12.78	17.77
BVPS (PLN)	44.8	53.0	52.0	57.8	67.3
Weighted average shares (m)	200	200	200	200	200
Average market cap (PLNm)	21,942	15,533	14,522	21,000	21,000
Enterprise value (PLNm)	15,419	9,747	9,547	15,183	13,913

Valuation Metrics

P/E (DB) (x)	5.8	5.3	5.7	6.6	4.7
P/E (Reported) (x)	5.8	5.3	5.7	6.6	4.7
P/BV (x)	2.36	0.53	2.04	1.82	1.56
FCF Yield (%)	16.5	10.7	9.1	13.8	18.4
Dividend Yield (%)	8.2	15.0	14.0	12.2	16.9
EV/Sales (x)	1.3	0.9	0.9	1.2	1.0
EV/EBITDA (x)	3.0	2.4	2.6	3.4	2.3
EV/EBIT (x)	3.3	2.7	3.1	3.9	2.6

Income Statement (PLNm)

Sales revenue	12,183	11,303	11,061	12,370	14,166
Gross profit	5,984	4,569	4,481	5,309	6,666
EBITDA	5,101	4,078	3,646	4,460	5,993
Depreciation	419	481	548	582	615
Amortisation	0	0	0	0	0
EBIT	4,682	3,596	3,098	3,879	5,378
Net interest income(expense)	-1	-2	-1	28	49
Associates/affiliates	0	0	0	0	0
Exceptionals/extraordinaries	0	0	0	0	0
Other pre-tax income/(expense)	-25	-40	-30	0	0
Profit before tax	4,656	3,554	3,067	3,906	5,427
Income tax expense	857	633	526	712	984
Minorities	0	0	0	0	0
Other post-tax income/(expense)	0	0	0	0	0
Net profit	3,799	2,920	2,540	3,194	4,443
DB adjustments (including dilution)	0	0	0	0	0
DB Net profit	3,799	2,920	2,540	3,194	4,443

Cash Flow (PLNm)

Cash flow from operations	4,456	2,749	2,487	4,147	5,106
Net Capex	-846	-1,081	-1,162	-1,250	-1,250
Free cash flow	3,611	1,669	1,326	2,897	3,856
Equity raised/(bought back)	0	0	0	0	0
Dividends paid	-3,394	-1,800	-2,336	-2,032	-2,555
Net inc/(dec) in borrowings	-11	-5	-7	0	0
Other investing/financing cash flows	236	-605	199	-22	-30
Net cash flow	442	-741	-818	843	1,270
Change in working capital	471	-334	-547	173	-225

Balance Sheet (PLNm)

Cash and other liquid assets	2,535	1,794	975	1,818	3,088
Tangible fixed assets	4,833	5,515	5,938	6,606	7,241
Goodwill/intangible assets	75	81	76	85	98
Associates/investments	2,357	3,759	3,482	3,482	3,482
Other assets	2,580	2,752	3,482	3,403	3,755
Total assets	12,380	13,901	13,953	15,393	17,664
Interest bearing debt	29	24	18	18	18
Other liabilities	3,385	3,285	3,531	3,810	4,192
Total liabilities	3,414	3,309	3,549	3,828	4,210
Shareholders' equity	8,966	10,591	10,404	11,566	13,454
Minorities	0	0	0	0	0
Total shareholders' equity	8,966	10,591	10,404	11,566	13,454
Net debt	-2,506	-1,769	-958	-1,800	-3,070

Key Company Metrics

Sales growth (%)	4.4	-7.2	-2.1	11.8	14.5
DB EPS growth (%)	5.4	-23.1	-13.0	25.7	39.1
EBITDA Margin (%)	41.9	36.1	33.0	36.1	42.3
EBIT Margin (%)	38.4	31.8	28.0	31.4	38.0
Payout ratio (%)	47.4	80.0	80.0	80.0	80.0
ROE (%)	44.5	29.9	24.2	29.1	35.5
Capex/sales (%)	6.9	9.6	10.5	10.1	8.8
Capex/depreciation (x)	2.0	2.2	2.1	2.1	2.0
Net debt/equity (%)	-28.0	-16.7	-9.2	-15.6	-22.8
Net interest cover (x)	nm	nm	nm	nm	nm

Source: Company data, Deutsche Bank estimates

Investment summary

KGHM acquires Canada-based development project...

KGHM signed an investment agreement with Abacus (a Canadian exploration company) to acquire:

- a 10% stake in Abacus in the latter's private placement for USD4.5m (CAD4.5m). KGHM's entry price is broadly in line with Abacus' current share price
- a 51% stake in a JV to which Abacus will insert the rights to the Afton-Ajax project, while KGHM will commit USD37m in cash. According to Abacus, it has already spent ca. USD20m on exploration works for the Ajax project. KGHM's cash injection to the JV is to be utilized to conduct a bankable feasibility study (ca. USD20m) and further explorations (ca. USD7m) Despite KGHM's 51% stake, Abacus will operate the JV project at this stage.

Additionally, KGHM has the option to acquire an additional 29% stake in the JV and become its operator for a maximum amount of USD35m (USD0.025 per pound for corresponding 29% of proven and probable copper equivalent reserves). The option can be utilized following the preparation of the bankable feasibility study.

The entire capex for the project amounts to USD535m, which KGHM will be obliged to arrange if it exercises its option to increase the stake in the JV to 80% (KGHM must also arrange financing for Abacus' 20% stake on commercially reasonable terms). If this happens, we believe the actual spending will be skewed towards 2012 and 2013.

...which should produce 50kt of Cu and 100k oz of Ag annually

In 2002, Abacus, a Toronto-listed Canadian exploration company, acquired the Afton open-pit mining area from Teck Cominco. The key area of the property is the Ajax deposit. Mining operations at Ajax began in 1989, only to be suspended in 1991 due to low metal prices. Production was launched once again in 1994 and halted in 1997. During the 2005 exploration drillings, the company tapped into potential gold-copper resources. Further drillings in 2006-08 provided Abacus with more details on the deposits.

According to resource estimates of the Ajax deposit (compliant with Canadian law), the area contains 1.3mt of copper (measured and indicated) and 2.7m oz of gold. The area has good access to existing infrastructure, including haul roads and power and water. Additionally, the proximity to highways and rail lines with direct access to deep sea ports allows the company to take advantage of the existing transportation infrastructure.

Figure 1: Ajax deposits – Estimated mineral resources

	Contained metal	
	Copper (kt)	Gold (k oz)
Measured	693	1,364
Indicated	621	1,287
Measured + Indicated	1,313	2,651
Inferred	177	404

Source: Deutsche Bank, Abacus

The company intends to complete the feasibility study for the project by the end of 2011 and mine construction in 2012-13. The expected annual production is ca. 50kt of copper and 100k oz of gold with a mine life of 23 years. The copper cash costs (after by-products) are estimated at ca. USD2,000/t.

Figure 2: Ajax's projected copper cash costs depending on gold price

Gold price (USD/oz)	700	800	900
Copper cash cost (USD/t)	2,579	2,380	2,182

Source: Deutsche Bank, Abacus

According to a preliminary study compliant with Canadian law (presented by Abacus), assuming copper prices of USD5,500/t and a gold price of USD900/oz, the Ajax project has a payback period of three years. See Figure 3 for details.

Figure 3: Payback of Ajax project (in years, discounted at 8%)

		Copper price (USD/t)		
		4,408	4,959	5,510
Gold price (USD/oz)	700	6.5	5.3	3.8
	800	6.0	4.9	3.4
	900	5.6	4.3	3.0

Source: Deutsche Bank, Abacus

Value enhancement?

KGHM's plan for international expansion is seen as a risk factor in the company's investment story, given 1) investors' preference for hefty dividends and 2) the company's poor track record. We believe the announced deal regarding entrance into the Ajax project should be seen as value-enhancing rather than value-detracting, as:

- **Risk for sizable dividend payment is low:** Short-term financing is insignificant (USD77m, assuming KGHM exercises its call option), lower than KGHM's one-month operating cash flow. The AGM decision on dividends will take place on 17 May; we reiterate our dividend forecast of PLN10/share.
- **The deal structure and Ajax's project economics look inviting:** KGHM's first outlays (ca. USD42m) will largely lay the ground work for the project (bankable feasibility study), and success will trigger further spending. Low copper cash costs (USD2,000/t, assuming current gold price) suggest the venture will be successful.

We believe execution is the major risk associated with the Ajax project. Abacus, the exploration company, does not have any established track record in operating mines. Also, KGHM has no experience in open-pit mining.

Investment thesis

Outlook

We rate KGHM a Buy, as we believe the improvement in copper market fundamentals (which are the major driver of the company's earnings) is not yet fully reflected in its share price, and we expect a positive total shareholder return on a 12-month basis. Copper was one of the best-performing commodities in 2009, as the economic recovery has continued and the restocking cycle has had a significant impact on supply/demand balances. Heading into mid-2010, the Deutsche Bank Commodity Team believes that copper is vulnerable to corrections, as drivers/catalysts which have pushed prices higher over the past several quarters have run their course. Our outlook becomes more constructive in 2011, as we anticipate a convergence at that time of both physical and financial demand. We expect average copper prices to increase by 28% to USD6,631/t for 2010E and by 17% to USD7,716/t for 2011E. Based on those assumptions, we expect KGHM's EPS to be PLN16.0 in 2010E and PLN22.2 in 2011E.

Valuation

We value KGHM on our sum-of-the-parts model (SOTP), analyzing the company's different assets separately with a target price of PLN115. We value the telecommunications assets (KGHM's 24.39% stake in mobile operator Polkomtel and a 100% stake in alternative carrier Dialog) using an EV/EBITDA-based comparative valuation at PLN20 per share. With regards to the copper business, we use an NPV model (major assumptions: WACC 11.6%, based on RFR of 5.75%, ERP of 5.0% and beta of 1.2), arriving at PLN86 per share. The remainder of our SOTP consists of the net cash we expect the company to hold onto in its balance sheet as of end-2010.

Risks

Lower-than-expected copper price and a stronger-than-expected PLN vs. USD rate are the major downside risks to our earnings forecasts and valuation. Looking at company-specific downside risks, we see the following: 1) lower-than-expected dividend payment and 2) an increase in capex for new businesses in which KGHM has very little experience.

Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist

Company	Ticker	Recent price*	Disclosure
KGHM	KGHM.WA	105.00 (PLN) 4 May 10	1,6,7,8,14

*Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies.

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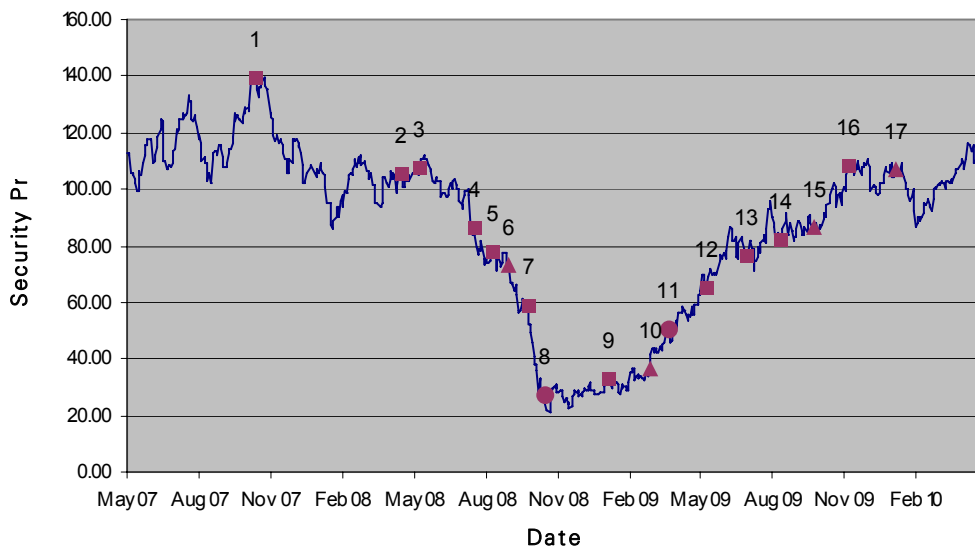
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Historical recommendations and target price: KGHM (KGHM.WA)

(as of 5/4/2010)



Previous Recommendations

- Strong Buy
- Buy
- Market Perform
- Underperform
- Not Rated
- Suspended Rating

Current Recommendations

- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

*New Recommendation Structure as of September 9, 2002

1.	16/10/2007:	Buy, Target Price Change PLN177.00	10.	4/3/2009:	Upgrade to Hold, Target Price Change PLN40.00
2.	20/4/2008:	Buy, Target Price Change PLN141.00	11.	27/3/2009:	Downgrade to Sell, Target Price Change PLN43.00
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4.	22/7/2008:	Sell, Target Price Change PLN80.00	13.	6/7/2009:	Sell, Target Price Change PLN58.00
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9.	9/1/2009:	Sell, Target Price Change PLN25.00			

Equity rating key **Equity rating dispersion and banking relationships**

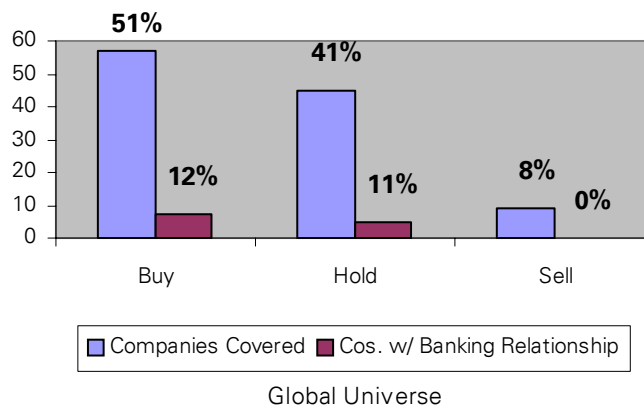
Buy: Based on a current 12- month view of total shareholder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield) , we recommend that investors buy the stock.

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2. Ratings definitions prior to 27 January, 2007 were:
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 - Sell: Expected total return (including dividends) of -10% or worse over a 12-month period



Regulatory Disclosures

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