Company

5 May 2010 | 8 pages

KGHM Polska Miedz SA (KGHM.WA)

Equity

Acquisition of Copper Assets in Canada

- **Agreement to acquire mining assets** — KGHM has announced that it has signed an Investment Agreement with Abacus Mining & Exploration Corporation (AME.V; C$0.29; Not Rated) ("Abacus", registered in Vancouver) regarding formation of a joint venture to explore copper-gold mining project Afton-Ajax located in British Columbia in Canada. Abacus Mining & Exploration Corporation is a mineral exploration and mining development company quoted on the TSX Venture Exchange in Canada.

- **Initial cost...** — According to the Agreement ***KGHM would acquire a 51% interest in the joint venture for US$37m*** (some Zl 110.7m) with Abacus bringing to the joint venture all the rights it owns to the Afton-Ajax deposit. The cash will be used to carry out a Bankable Feasibility Study and for further exploration.

- **...additional agreement** — Following completion of the Bankable Feasibility Study ***KGHM will have an option to acquire an additional 29% stake*** in the joint venture for no more than US$35 million (Zl 104.7 million). Final agreement between the two parties should be signed in 2Q10 but no later than by 30 September 2010. Realisation of the Investment Agreement is subject to approval by the shareholders of Abacus. In addition, the Investment Agreement also provides for the acquisition of up to 10% of Abacus' shares (15 million shares) through private placement for a total amount of CAD 4.5m (the equivalent of Zl 13.3m).

- **What KGHM is buying** — According to the technical report conducted by Wardrop Engineering Inc. from 29 July 2009 the project assumes annual copper production at a level of 50,000t and gold production at a level of 100 thousand troz. A 23-year mine-life is predicted, beginning from 2013 with the production costs estimated at a level of approx. US$2,000/t.

- **Potential capex** — The agreement includes a commitment by ***KGHM to arrange financing for the project capex of US$535m*** (some Zl 1.6bn) after it executes its option to acquire a further 29% in the joint venture company.

- **Potential value added** — Based on the provided data our very preliminary "ball park" estimated value added from the project (assuming that it would be successful) given a copper price of US$7,000/t and Zl/US$ exchange rate of 3 is Zl 5.8/share.

- **Risks** — One of the biggest risks of the project is its very initial stage of development and therefore the production costs and output could change significantly in the future. In addition KGHM has no experience of successfully running international operations.

Sell/High Risk	**3H**
Price (04 May 10)	ZL105.00
Target price	ZL94.70
Expected share price return	-9.8%
Expected dividend yield	9.7%
Expected total return	**-0.1%**
Market Cap	ZL21,000M
	US$7,070M

Price Performance (RIC: KGHM.WA, BB: KGH PW)

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Fiscal year end 31-Dec	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	5.5	7.2	8.2	7.1	6.9
EV/EBITDA adjusted (x)	3.2	4.0	4.5	4.0	3.9
P/BV (x)	2.3	2.0	1.9	1.8	1.6
Dividend yield (%)	16.2	8.6	11.1	9.7	8.6
Per Share Data (ZL)					
EPS adjusted	18.99	14.60	12.74	14.87	15.23
EPS reported	18.99	14.60	12.74	14.87	15.23
BVPS	44.83	52.96	54.02	58.69	64.93
DPS	16.97	9.00	11.68	10.19	9.00
Profit & Loss (ZLM)					
Net sales	12,183	11,303	10,954	11,735	11,938
Operating expenses	-7,501	-7,707	-7,829	-8,130	-8,253
EBIT	**4,682**	**3,596**	**3,125**	**3,605**	**3,685**
Net interest expense	-1	0	-18	90	100
Non-operating/exceptionals	-25	-43	-22	-23	-24
Pre-tax profit	**4,656**	**3,554**	**3,085**	**3,671**	**3,761**
Tax	-857	-633	-537	-698	-715
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**3,799**	**2,920**	**2,548**	**2,974**	**3,047**
Adjusted earnings	3,799	2,920	2,548	2,974	3,047
Adjusted EBITDA	5,101	4,078	3,665	4,189	4,316
Growth Rates (%)					
Sales	4.4	-7.2	-3.1	7.1	1.7
EBIT adjusted	6.3	-23.2	-13.1	15.3	2.2
EBITDA adjusted	6.6	-20.1	-10.1	14.3	3.0
EPS adjusted	5.4	-23.1	-12.7	16.7	2.4
Cash Flow (ZLM)					
Operating cash flow	**4,468**	**2,749**	**2,994**	**3,487**	**3,651**
Depreciation/amortization	419	481	540	584	631
Net working capital	-365	-598	-94	-71	-27
Investing cash flow	**-578**	**-1,722**	**-1,235**	**-1,646**	**-1,250**
Capital expenditure	-846	-1,081	-1,235	-1,646	-1,250
Acquisitions/disposals	119	-1,308	0	0	0
Financing cash flow	**-3,406**	**-1,809**	**-2,336**	**-2,039**	**-1,800**
Borrowings	-1	-5	0	0	0
Dividends paid	-3,394	-1,800	-2,336	-2,039	-1,800
Change in cash	**442**	**-741**	**-577**	**-198**	**601**
Balance Sheet (ZLM)					
Total assets	**12,380**	**13,901**	**14,068**	**15,112**	**16,393**
Cash & cash equivalent	2,535	1,794	1,217	1,018	1,620
Accounts receivable	772	1,223	1,185	1,269	1,291
Net fixed assets	4,833	5,515	6,209	7,270	7,888
Total liabilities	**3,414**	**3,309**	**3,264**	**3,373**	**3,408**
Accounts payable	561	695	680	722	739
Total Debt	29	24	24	24	24
Shareholders' funds	**8,966**	**10,591**	**10,804**	**11,739**	**12,985**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	41.9	36.1	33.5	35.7	36.2
ROE adjusted	44.5	29.9	23.8	26.4	24.6
ROIC adjusted	71.6	45.5	33.0	33.0	30.6
Net debt to equity	-28.0	-16.7	-11.0	-8.5	-12.3
Total debt to capital	0.3	0.2	0.2	0.2	0.2

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Our very preliminary “ball park” valuation of the project per KGHM share is some Zl 5.8. However, it is very sensitive to the copper price and Zl/US$ exchange rate assumption. Please note that given the project’s risk we use a discount rate of 15% and assume potential 3% growth in production cost. At this stage we are not adding the potential value of the project to our KGHM valuation given the variables noted above and that the deal has yet to be approved by Abacus shareholders.

Figure 1. Per Share Value of the Canadian Copper Project Sensitivity Table

	Zl/US$ Exchange Rate							
Copper Price	**2.50**	**2.70**	**2.80**	**2.90**	**3.00**	**3.10**	**3.20**	**3.30**
$4,500	-0.3	0.0	0.1	0.3	0.4	0.6	0.7	0.9
$5,000	0.6	1.0	1.1	1.3	1.5	1.7	1.9	2.0
$5,500	1.5	1.9	2.1	2.4	2.6	2.8	3.0	3.2
$6,000	2.4	2.9	3.1	3.4	3.6	3.9	4.1	4.4
$6,500	3.3	3.8	4.1	4.4	4.7	5.0	5.3	5.6
$7,000	4.2	4.8	5.1	5.4	**5.8**	6.1	6.4	6.7
$7,500	5.0	5.8	6.1	6.5	6.8	7.2	7.6	7.9
$8,000	5.9	6.7	7.1	7.5	7.9	8.3	8.7	9.1

Source: Citi Investment Research/Dom Maklerski Banku Handlowego S.A. estimates

KGHM Polska Miedz SA

Company description

KGHM is the sixth-largest producer of copper in the world, with production of over 500,000 tonnes (some 2.7% of global production). It is also the world's second-largest silver producer, with output of around 1,100 tonnes, around 7% of global production. Sales of copper constitute 80% of revenues, and silver around 15%. It is a high-cost copper producer due to the nature of its mines, with production cost at around Zl 12,000/t. KGHM is still under state control, with strong labour unions. The company has stakes in mobile and fixed-line telephony. Some 34% of copper is sold in Poland, 22% in Germany, 15% in France and 10% in China. The major markets for silver sales are the UK (56%), Germany (18%), Belgium (13%) and Poland (9%).

Investment strategy

We rate KGHM Sell/High Risk (3H). The stock offers exposure to the still strong copper market expected in the years 2010 and 2011 but we see it as simply too expensive offering in our view very limited upside potential. On a one-year forward PE basis on our and consensus expected numbers, KGHM trades at some 37% discount to its peers whereas it used to trade at a deep discount ranging from 40%-60%. The stock appears demanding on a 12-month trailing PE multiple as well as on its historical forward multiple which averages at around 5.5x for the last seven years. Risk still exists from the strengthening of the local currency, likely upturn in copper production costs next year and the risk of copper price correction especially as China slows down its purchases.

Valuation

Using multiples-based (PE, EV/EBITDA) and SOTP valuation methods, we derive a valuation range for KGHM of Zl 69 to Zl 105 per share. However, we set a target price of Zl 94.7, which we derive by valuing the mining assets at Zl 70.6/share (using a mid-cycle PE of 5.5x), telco assets at Zl 19.1/share (based on PE and EV/EBITDA multiples and the recent transaction when TDC was selling its stake) with the remainder being cash at the end of 2010. In the meantime we also expect investors to receive a dividend payment of Zl 10.2/share out of 2009 earnings in mid-year 2010.

Risks

We rate KGHM as High Risk based on its high-cost position, which is difficult to reverse and raises the profitability breakeven point. On the other hand, strong earnings this year and the high cash position on the balance sheet at the end of the year increase probability of a large dividend payment in 2010. Still, we believe that the stock is susceptible to changes in copper prices and Zl/US$ exchange rates, and therefore its earnings volatility is much higher than for the average Polish company. The following risk factors may cause the share price to deviate from our target price: higher-than-expected salary increases and increased union demands for bonus payments and unexpectedly large hedging losses both constitute downside risks. At the same time, potential upside risk factors include an unexpected significant strengthening of the US$ versus zloty, announcement of a deep redundancy programme, higher-than-expected copper prices for 2010 and 2011, higher-than-expected silver prices, and a very successful disposal of the fixed-line and mobile telephony business.

Appendix A-1

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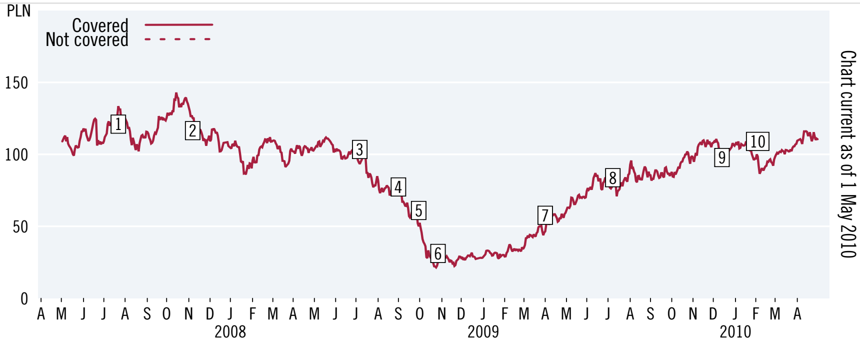
Analyst: Rafal Wiatr, CFA



	Date	Rating	Target Price	Closing Price
1	23-Jul-07	3H	*119.00	133.50
2	7-Nov-07	3H	*110.00	125.20
3	7-Jul-08	*1H	*140.00	93.30
4	1-Sep-08	1H	*115.00	74.90
5	30-Sep-08	1H	*85.00	49.95
6	28-Oct-08	1H	*40.00	25.20
7	1-Apr-09	*2H	*44.10	46.45
8	8-Jul-09	2H	*81.00	78.50
9	14-Dec-09	*3H	*70.90	100.50
10	3-Feb-10	3H	*94.70	98.65

* Indicates change

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