29 August 2011

Update

BRE Bank Securities

Oil & Gas
Poland

Lotos

LTS PW; LTOS.WA

Reduce
(Upgraded)

Current price	**PLN 30.33**
Target price	**PLN 27.40**
Market cap	PLN 3.9bn
Free float	PLN 1.8bn
Avg daily trading volume (3M)	PLN 23.1m

Shareholder Structure

State Treasury	53.19%
Others	46.81%

Sector Outlook

Refining margins have been under considerable pressure from appreciating crude and weakening demand for fuels. The situation is improving now, but a plunge in the Urals/Brent pricing differential poses a problem. The reported earnings may be under pressure from declining crude prices and the consequent negative LIFO effect. The situation is made worse by the competitive pressure in domestic wholesale and retail.

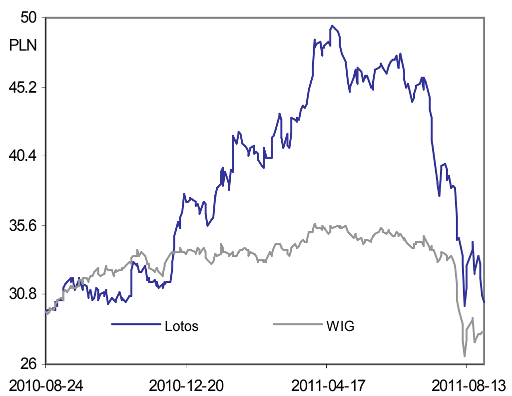
Company Profile

Grupa Lotos is the second largest refining group in Poland, with annual processing capacity of 10.5m tons per year. The company also runs the second largest chain of fuel stations in Poland (318), and owns upstream assets in the Baltic Sea (Pertrobaltic, Geonafta) and the Norwegian Sea (estimated at 7.4 Mt).

Important dates

03.11– Q3 2011 report

Lotos vs. WIG



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Q2 Cools Down Overly High Expectations

We do not believe that the recent very deep plunge in the price of the Lotos stock (by 38% since the April peak) has made it a buy opportunity; indeed, it has only made the valuation more realistic in the face of the very unfavorable economic environment for the refining business. The current share price implies a 2011 EV/LIFO EBITDA of 8.1 vs. 5.9 for Orlen; moreover, Lotos's debt is five times its LIFO EBITDA vs. 1x for Orlen after adjustment for income from Polkomtel. In this context, the balance of risks looks much better for PKN Orlen, all the more so that it has diversified sources of earnings (petrochemicals, retail). A privatization premium for Lotos is unwarranted, because the Treasury is very unlikely to sell it for political reasons. We are lowering our target price from PLN 28.4 per share to PLN 27.4 per share (the reduction in our forecasts is partially offset by a reduction in the risk-free rate), but given the current price of the stock, we are upgrading our rating from sell to reduce.

Very weak showing for Q2 2011

Lotos's earnings for Q2'11, just as its performance for Q1'11, showed that in a difficult economic environment, even the new refinery, with its more attractive output mix, cannot generate satisfactory margins, all the more so that crack spreads on diesel, its biggest exposure, remain relatively weak. Had it not been for inventory revaluation, in H1'11 Lotos would have generated an operating profit of a mere PLN 215m, including PLN 107m from the upstream business. In Q2, additional negative surprises came from the strongly negative cash flows from operations and net debt, which climbed above PLN 6.2bn. The depreciation of the zloty vs. the USD may cause net debt to expand by a further PLN 300m in the next quarter.

Economic environment for refining remains weak

In the past few weeks, following a price correction on petroleum, benchmark refining margins have improved. However, we have also seen the Urals/ Brent differential plunge (to just USD 0.3-0.4/bbl. vs. USD 2.9/bbl. average in H1'11), which was a consequence of the freeing of IEA's reserves, increased supply from Saudi Arabia and the likelihood that Libyan crude oil will return to the market quicker than expected. Lotos continues to experience pressure on its wholesale margin ("inland premium") and its retail margins in Poland, where its competition with Orlen has become more intensive with the rising throughput capacity. In contrast to its main rival, the Company is not diversified and cannot offset weak refining profits with a strong performance in petrochemicals or retail. Given the above tendencies, we have cut our expectations for the industry's margins, although we still assume that they will improve from the current record-low levels.

(PLN m)	2009	2010	2011F	2012F	2013F
Revenue	14 321.0	19 680.5	27 650.3	28 326.4	27 538.4
EBITDA	704.6	1 451.3	1 606.5	1 501.7	1 717.6
EBITDA margin	*4.9%*	*7.4%*	*5.8%*	*5.3%*	*6.2%*
EBIT	419.8	1 061.4	1 008.3	776.0	983.2
Net profit	900.8	679.2	827.9	409.7	504.3
DPS	0.00	0.00	0.00	0.00	1.58
P/E	4.4	5.8	4.8	9.6	7.8
P/CE	3.3	3.7	2.8	3.5	3.2
P/BV	0.6	0.5	0.5	0.5	0.4
EV/EBITDA	13.2	6.8	6.1	6.1	5.2
DYield	0.0%	0.0%	0.0%	0.0%	5.2%

Disappointing Second Quarter In Refinery

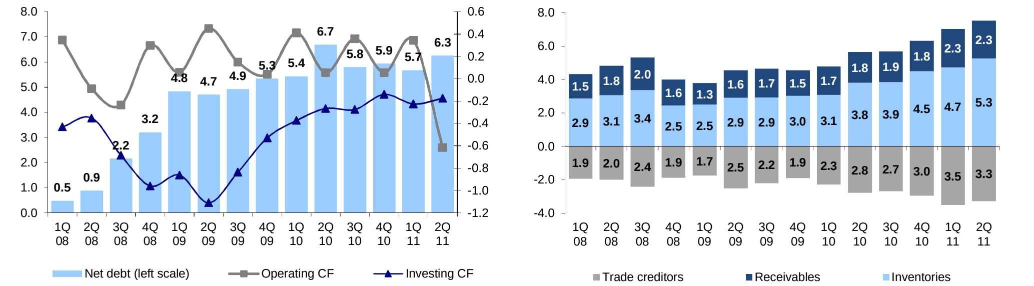
Reported vs. forecasted Q2 2011 results

(PLN m)	Q2 2011	Q2 2010	change	2011F	Actuals vs. Our Forecast	Consensus	Actuals vs. Consensus	1H'2011	1H'2010	change
Revenue	6 777.1	4 747.1	42.8%	7 112.9	-4.7%	7 152.0	-5.2%	13 296.6	8 658.7	53.6%
EBITDA	466.8	383.8	21.6%	502.8	-7.2%	461.0	1.3%	1 000.5	595.6	68.0%
EBITDA margin	*6.9%*	*8.1%*	-	*7.1%*	-	-	-	*7.5%*	*6.9%*	-
EBIT	321.1	292.4	9.8%	336.2	-4.5%	316.0	1.6%	733.7	424.4	72.9%
Pre-tax income	301.2	-822.5	-	402.4	-25.2%	-	-	1 052.7	-821.7	-
Net income	253.4	-646.0	-	326.0	-22.3%	311.0	-18.5%	888.7	-623.1	-

Source: Lotos, F – forecasts by BRE Bank Securities; Consensus estimates by PAP

At first glance, Lotos's consolidated Q2 2011 EBIT of PLN 321m was in line with our forecast and consensus estimates. A closer look, however, reveals that it was built on much higher-than-anticipated LIFO effects (PLN 240m vs. PLN 110m expected) and one-time other operating income in the amount of PLN 10m. Adjusted for LIFO effects, EBIT figures to a mere PLN 81m, less than our PLN 226m estimate and the PLN 134m posted in Q1 2011 – a grave disappointment given seasonal patterns and the fact that the new plant put in place under the "10+" program was working at full capacity. Also disappointing were Lotos's Q2 2011 financial expenses which reached PLN 20m in spite of in-line F/X differences (PLN 77.2m vs. PLN 66m forecasted). Drivers included hedging losses (a PLN 23m loss on interest rate hedges and a PLN 14m loss on F/X and CO2 hedges), reversal of a PLN 20m portion of the proceeds on the acquisition of Geonafta recognized in Q1, and interest expenses (now fully recognized under financing expenses). According to the new accounting approach, part of F/X differences on investment loans are booked through equity (PLN 83.4m).

Net debt (PLN bn) vs. cash flows and working capital



Source: BRE bank Securities based on Lotos data

Second-quarter operating cash flow displayed a disappointing downward slide relative to the high Q1 level, dropping to a negative PLN 616m due to increased negative working capital which surged to PLN 750m driven by rising inventories (strategic reserves and price hikes) and reduced trade creditors. The working capital movements may have been an effect of disproportionate payables growth in 1Q (which boosted the period's OCF) and mismatched VAT cash flows. The short cash conversion cycles reported in Q1 (49 days compared to a five-year average of 55 days) seemed impossible to maintain. As a result, Lotos's net debt after the six months ended 30 June 2011 stood at PLN 6.26bn (after a PLN 591m q/q increase) even in spite of the positive effects of US dollar debt revaluations and a stronger zloty (PLN 147.9m total). The current ratio of debt to LIFO EBITDA (yearly moving average) of 5.1 is far from safe, especially when we consider that the average includes the strong results of Q3 2010 which are not likely to be repeated this third quarter amid a less favorable macroeconomic environment. Note also that if the current USD/PLN exchange rate persists until the end of the year, Lotos's dollar debt will increase by PLN 300m. The combination of weak cash flows and unfavorable macro conditions is reason for concern at a time when the company is starting to pay back investment loans. We expect principal loan payments to amount to PLN 185m in H2 2011 and PLN 371m in 2012 (PLN 580m with interest).

Consolidated quarterly results by operating segment

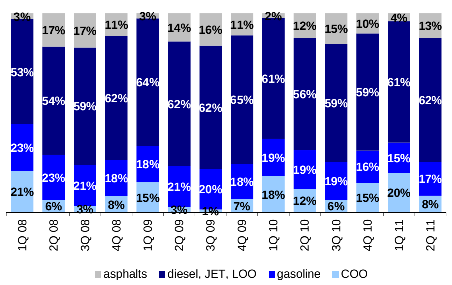
	1Q 09	2Q 09	3Q 09	4Q 09	1Q 10	2Q 10	3Q 10	4Q 10	1Q 11	2Q 11
EBIT	**12 760**	**158 015**	**184 197**	**64 800**	**132 000**	**292 406**	**332 190**	**304 800**	**412 553**	**321 128**
upstream	14 600	-8 900	-6 800	-5 600	39 400	35 100	6 100	-55 900	23 600	84 300
refineries	-5 800	149 700	158 800	86 600	101 500	263 600	281 200	343 200	403 500	275 600
LIFO effects	*100 900*	*186 900*	*63 000*	*97 300*	*69 300*	*253 200*	*-81 700*	*177 700*	*278 100*	*240 100*
retail	4 000	16 600	31 500	3 500	-2 600	8 000	12 300	-3 800	-12 800	-12 300
other	-100	-100	0	-200	100	-1 000	-100	-400	-1 200	1 100
LIFO EBIT	**-88 140**	**-28 885**	**121 197**	**-32 500**	**62 700**	**39 206**	**413 890**	**127 100**	**134 453**	**81 028**
D&A expenses	62 400	67 500	72 500	82 400	79 779	91 401	102 273	113 279	121 196	145 665
EBITDA	**75 160**	**225 515**	**256 697**	**147 200**	**211 779**	**383 807**	**434 463**	**418 397**	**533 749**	**466 793**
Financial operations	-791 600	763 000	545 102	173 253	-131 185	-1 114 900	966 400	-59 700	338 898	-19 914
Pre-tax income	-784 240	921 015	729 299	238 053	815	-822 494	1 298 590	245 100	751 451	301 214
Net income	**-650 073**	**744 716**	**578 764**	**227 321**	**22 867**	**-645 984**	**1 050 911**	**251 300**	**635 245**	**253 435**
Prices of Brent crude (USD/Bbl)	45.0	59.3	68.3	75.0	76.8	78.4	76.3	86.9	104.9	116.8
Refining margin (USD/Bbl)	4.2	3.8	2.9	0.9	2.6	4.0	2.5	3.2	1.7	2.6
Urals/Brent spread	0.8	0.7	0.3	0.3	1.1	1.3	1.3	1.3	2.9	3.3
Avg. USD/PLN exchange rate	3.45	3.27	2.94	2.83	2.89	3.15	3.11	2.92	2.87	2.75
USD/PLN at period end	3.54	3.17	2.89	2.85	2.87	3.36	2.93	2.96	2.82	2.75
Crude oil output ('000 tons)	1 160	1 229	1 514	1 559	1 615	2 061	2 196	2 224	2 223	2 220
Sales ('000 tons)	1 645	1 801	2 081	2 071	1 899	2 073	2 327	2 487	2 467	2 355
Oil extraction volume ('000 tons)	33	38	43.5	60.9	76.4	38.5	37.5	34.1	50.3	56.9
Oil sales ('000 tons)	38.8	57.6	28.1	56.5	87.6	51.0	28.6	26.1	46.1	84.6

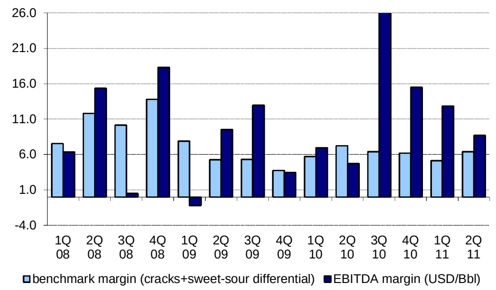
Source: Lotos

Refineries

The Refining segment was the biggest disappointment of the second quarter with a LIFO EBIT (adjusted for losses incurred by the retail division) of a meager PLN 35m vs. PLN 125m in Q1, and this after PLN 20m lower-than-forecasted D&A expenses (new assets are depreciating at a slower rate). There was a surprising 4.6% q/q drop in wholesale sales, and a flat oil output. The dismal performance of Lotos's core business was a consequence of unfavorable macro conditions combined with a decreasing geographic premium and increasing local competition which also affected the second-quarter results of rival PKLN Orlen. To maximize profits during these tougher times, Lotos's Management decided not to operate the "10+" systems at full capacity for now, suggesting that the company will not achieve the nominal quarterly output of 2.6-2.7 million tons in the second half of the year. Note that Lotos was not able to mitigate the impact of the adverse market conditions in spite of a much improved refinery slate (with a lower share of heavy fuel oil and a higher share of diesel and gasoline).

Product slate and standalone EBITDA vs. benchmark margins

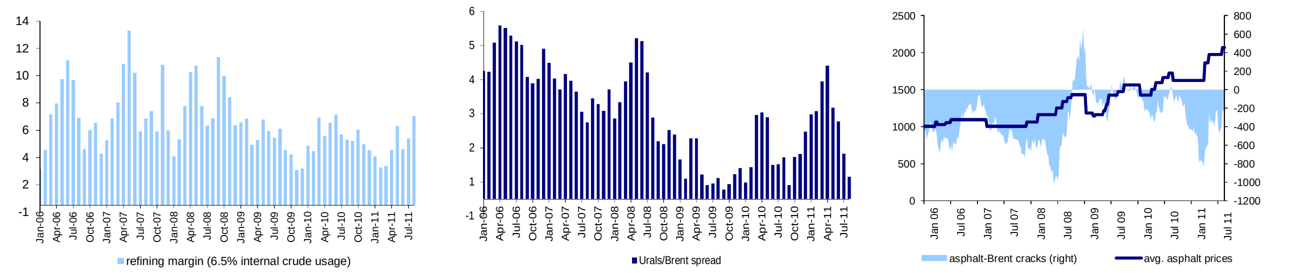




Source: Lotos, estimates by BRE Bank Securities

As for Lotos's outlook for the rest of the year, the oil industry fundamentals remain relatively weak. On the one hand, the August drop in oil prices has widened benchmark refining margins (according to our estimates, the average benchmark this past month was about USD 1.6/Bbl higher than in July). On the other hand, however, the Urals/Brent spread has contracted from a H1 2011 average of USD 2.9/Bbl to just USD 0.3-0.4/Bbl today. The main reasons underpinning this reduction in the gap between the price of heavy and light crude are: higher output at OPEC countries (with an increase by 1.5% m/m in June and by a further 1% in July, mostly through light crude oil from Saudi Arabia which was supposed to offset the lack of supplies from Libya), "concerns" that the Libyan crude may return to the global markets earlier than previously expected (as a reminder, it was the outbreak of the revolution in Libya in March that led to an increase in crude prices and in the premium for its light varieties), a reduction in the supply of Russian Rebco crude caused by transfer capacity limitations on the Druzhba pipeline, and a seasonal increase in refinery demand after a period of maintenance downtime earlier in the year. Further, competition remains intense in the domestic market, and it is going to keep Lotos's land premium tight as PKN Orlen finishes scheduled maintenance and increases diesel capacity. The profits for Q3 2011 will be supported by seasonally higher sales of asphalt, but the support will not be as robust as in Q3 2010 when the crack spread was PLN -63/t compared to today's PLN -300/t (in Q3 2010, Lotos generated a LIFO EBIT of a whopping PLN 413m).

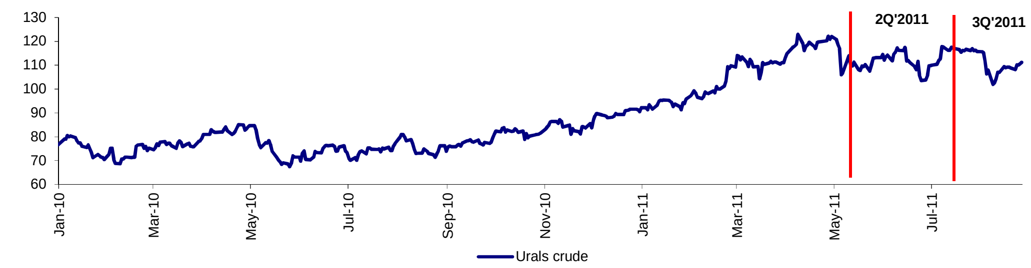
Benchmark refining margins, Urals/Brent spread (USD/Bbl), asphalt crack spreads (PLN/t)



Source: Bloomberg, estimates by BRE Bank Securities

A key factor in the preparation of full-year financial forecasts for refineries are assumptions with regard to crude oil prices whose current volatility makes it difficult to estimate the LIFO effect in the upcoming quarters. In H1, the appreciating crude boosted EBIT by a total of PLN 0.52bn. The sharp downward correction in early August suggested a high negative revaluation effect in Q3, but a portion of these losses has been made up for recently, and their scale was further neutralized by the depreciation of the zloty vs. the USD. Assuming that the price per barrel of Brent crude stays put, the average for Q3 should amount to ca. USD 111/Bbl, which would entail a q/q reduction by less than USD 6/Bbl. Taking into account the change in the USD/PLN exchange rate, this would imply losses of ca. PLN 30-40m. However, in our model we assume that with the supply-side situation in the market for light crude improving (Libya) and with fuel demand risks in Europe on the rise, the price of Brent crude will fall more than that (perhaps not through an outright decline in global benchmarks but through a narrowing of the spread vs. WTI crude, which now exceeds USD 22/bbl.) Were the price to fall towards USD 102/Bbl (-6% vs. the current levels), Lotos's inventory revaluation loss in H2'11 would amount to ca. PLN 140m, which is the scenario we consider in our forecasts.

Urals crude prices (PLN/Bbl)



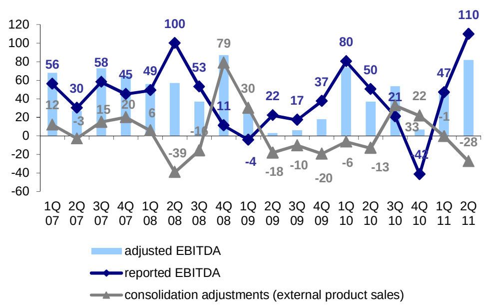
Source: Bloomberg, estimates by BRE Bank Securities

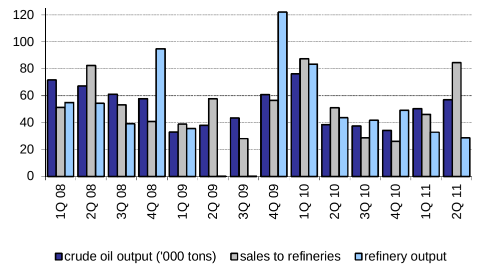
Also affecting the 2011 second-quarter results of the Downstream business was Retail which posted another quarterly loss of PLN 12.3m, adding to a 2011 first-half EBIT loss of PLN 25m. The ongoing price war in the domestic market means that the Lotos service stations are not likely to recover in Q3 2011. Leading Polish refiners have recently made a promise to keep gasoline prices below PLN 5 a liter, which may seem surprising given their record low retail margins, but makes sense to them as a sales volume saving measure. Granted, the weather in Poland this summer does not encourage vacation travel, affecting fuel and non-fuel sales at service stations, but to our mind this is not a good enough justification for the aggressive pricing policy. For example, service stations today are charging PLN 4.93 per liter of 95 unleaded, earning a meager 6 groszys on each liter.

Upstream

Upstream was the highlight of Lotos's Q2 2011 results, reporting an EBIT of PLN 84m, well ahead of our PLN 33m estimate and the Q1 figure of PLN 23m, and stellar sales volumes in excess of 80,000 tons (we expected 58kt). The main driver behind such strong results was Petrobaltic which generated an operating profit of PLN 60m compared to PLN 8.9m in Q1'11. Such a major q/q shift is a consequence of the accounting approach to the upstream margin and the related intersegmental eliminations (PLN -27m this quarter). This means that the high Q2 sales were a non-recurring achievement (fueled by inventory sell-off) and that future quarterly sales will be consistent with production volumes (57kt). Upstream's profits are supported by the February Lithuanian acquisition Geonafta which, with a quarterly crude output of 22kt, can currently generate an operating profit of about PLN 24m each quarter. Even so, our financial projections for Upstream had to be revised downward to account for another delay in the Yme project. With production there not scheduled to launch until Q2 2012, this leaves a gap in this year's expected revenue. Our revised forecast assumes that Yme will provide about 200kt of crude in 2012. Lotos's Management are disappointed with the Yme investment and they are considering suing its operator, Talisman, in which case they would have to prove that Talisman violated the interests of the concession holders. Lotos expects a status update on the Yme project from Talisman in September, based on which it will decide whether or not to sue.

Adjusted quarterly results of Upstream (PLN m) vs. oil extraction and sales volumes





Source: BRE Bank Securities based on Lotos data

Valuation of Lotos's Upstream assets

(PLN m)	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F	2020F	2021F
POLAND											
Revenue	**309.9**	**273.8**	**264.3**	**910.4**	**910.4**	**910.4**	**910.4**	**910.4**	**910.4**	**910.4**	**910.4**
EBITDA	**172.5**	**134.8**	**129.4**	**494.6**	**494.6**	**494.6**	**494.6**	**494.6**	**494.6**	**494.6**	**494.6**
EBITDA margin	*55.7%*	*49.2%*	*49.0%*	*54.3%*	*54.3%*	*54.3%*	*54.3%*	*54.3%*	*54.3%*	*54.3%*	*54.3%*
D&A expenses	63.4	63.4	63.4	155.4	156.4	158.5	161.7	165.8	170.8	170.8	170.8
EBIT	**109.1**	**71.4**	**66.0**	**339.2**	**338.2**	**336.0**	**332.9**	**328.7**	**323.8**	**323.8**	**323.8**
EBIT margin	*35.2%*	*26.1%*	*25.0%*	*37.3%*	*37.1%*	*36.9%*	*36.6%*	*36.1%*	*35.6%*	*35.6%*	*35.6%*
Tax on EBIT	20.7	13.6	12.5	64.4	64.3	63.8	63.2	62.5	61.5	61.5	61.5
CAPEX	250.0	250.0	250.0	250.0	78.2	79.3	80.9	82.9	85.4	85.4	85.4
FCF	**-98.2**	**-128.8**	**-133.1**	**180.1**	**352.1**	**351.5**	**350.5**	**349.2**	**347.6**	**347.6**	**347.6**
WACC	*9.7%*	*9.7%*	*9.7%*	*9.7%*	*9.7%*	*9.7%*	*9.7%*	*9.7%*	*9.7%*	*9.7%*	*4.4%*
discount factor	*95.5%*	*87.0%*	*79.3%*	*72.3%*	*65.9%*	*60.0%*	*54.7%*	*49.9%*	*45.4%*	*41.4%*	*39.7%*
PV FCF	-93.8	-112.1	-105.6	130.2	231.9	211.0	191.7	174.1	158.0	144.0	137.8
NORWAY											
Revenue	**0.0**	**403.9**	**584.9**	**498.2**	**432.4**	**366.6**	**300.8**	**235.0**	**169.2**	**169.2**	**169.2**
EBITDA	**0.0**	**255.1**	**369.4**	**314.7**	**273.1**	**231.6**	**190.0**	**148.4**	**106.9**	**106.9**	**106.9**
EBITDA margin	-	*63.2%*	*63.2%*	*63.2%*	*63.2%*	*63.2%*	*63.2%*	*63.2%*	*63.2%*	*63.2%*	*63.2%*
D&A expenses	0.0	83.3	83.3	83.3	83.3	83.3	75.0	75.0	75.0	75.0	50.0
EBIT	**0.0**	**171.8**	**286.1**	**231.3**	**189.8**	**148.2**	**115.0**	**73.4**	**31.9**	**31.9**	**56.9**
EBIT margin	-	*42.5%*	*48.9%*	*46.4%*	*43.9%*	*40.4%*	*38.2%*	*31.2%*	*18.8%*	*18.8%*	*33.6%*
Tax on EBIT	0.0	134.0	223.2	180.4	148.0	115.6	89.7	57.3	24.9	24.9	44.4
CAPEX	50.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0
FCF	**-50.0**	**71.1**	**96.3**	**84.2**	**75.1**	**65.9**	**50.3**	**41.2**	**32.0**	**32.0**	**12.5**
WACC	*6.9%*	*6.9%*	*6.9%*	*6.9%*	*6.9%*	*6.9%*	*6.9%*	*6.9%*	*6.9%*	*6.9%*	*6.9%*
discount factor	*96.7%*	*90.4%*	*84.5%*	*79.1%*	*73.9%*	*69.1%*	*64.6%*	*60.4%*	*56.5%*	*52.8%*	*49.4%*
PV FCF	-48.3	64.3	81.4	66.6	55.5	45.6	32.5	24.9	18.1	16.9	6.2
LITHUANIA											
Revenue	**249.5**	**221.3**	**213.6**	**206.0**	**206.0**	**206.0**	**206.0**	**206.0**	**206.0**	**0.0**	**0.0**
EBITDA	**141.1**	**125.2**	**120.9**	**116.5**	**116.5**	**116.5**	**116.5**	**116.5**	**116.5**	**0.0**	**0.0**
EBITDA margin	*56.6%*	*56.6%*	*56.6%*	*56.6%*	*56.6%*	*56.6%*	*56.6%*	*56.6%*	*56.6%*	-	-
D&A expenses	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	0.0	0.0
EBIT	**88.1**	**72.2**	**67.9**	**63.5**	**63.5**	**63.5**	**63.5**	**63.5**	**63.5**	**0.0**	**0.0**
EBIT margin	*35.3%*	*32.6%*	*31.8%*	*30.8%*	*30.8%*	*30.8%*	*30.8%*	*30.8%*	*30.8%*	-	-
Tax on EBIT	13.2	10.8	10.2	9.5	9.5	9.5	9.5	9.5	9.5	0.0	0.0
CAPEX	187.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0	0.0	0.0
FCF	**-59.1**	**64.3**	**60.7**	**57.0**	**57.0**	**57.0**	**57.0**	**57.0**	**57.0**	**0.0**	**0.0**
WACC	*8.5%*	*8.5%*	*8.5%*	*8.5%*	*8.5%*	*8.5%*	*8.5%*	*8.5%*	*8.5%*	*8.5%*	*8.5%*
discount factor	*96.0%*	*92.2%*	*88.5%*	*85.0%*	*81.6%*	*78.3%*	*75.2%*	*72.2%*	*69.3%*	*66.6%*	*63.9%*
PV FCF	-56.7	59.3	53.7	48.4	46.5	44.7	42.9	41.2	39.5	0.0	0.0

Value of Polish deposits	893.7
Value of Norwegian deposits	330.9
Value of Lithuanian deposits*	288.8
Provision for drill site reclamation	-217.1
Net value of deposits	**1 513.4**
Value per share	**11.7**
EV/2P (USD/Bbl)	11.1

**adjusted for acquisition costs*

Macroeconomic Assumptions

The economic assumptions underpinning our DCF model are presented below.

USD/Bbl	2008	2009	2010	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F
Brent crude	98.0	62.0	79.7	108.6	95.0	95.0	95.0	95.0	95.0	95.0	95.0	95.0
Urals crude	95.1	61.2	78.3	106.8	93.5	93.2	93.2	93.2	93.2	93.2	93.2	93.2
Urals-Brent spread	2.9	0.8	1.4	1.8	1.5	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Lotos's product margin*	8.0	3.7	4.9	8.0	8.0	8.0	7.9	7.9	7.9	7.8	7.8	7.8
thousands of tons												
Crude oil throughput	6 204	5 462	8 096	9 240	10 500	10 500	10 500	10 500	10 500	10 500	10 500	10 500
Output in Poland	258	175	187	140	140	140	500	500	500	500	500	500
Output in Lithuania	-	-	-	96	96	96	96	96	96	96	96	96
Output in Norway	-	-	-	-	200	300	265	230	195	160	125	90

	2008	2009	2010	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F
USD/PLN	2.42	3.12	3.02	2.86	2.90	2.80	2.70	2.70	2.70	2.70	2.70	2.70
EUR/PLN	3.48	4.33	3.99	4.04	4.10	3.96	3.81	3.81	3.81	3.81	3.81	3.81

**margin estimates as of 2011 factor in the full effects of the 10+ program*
Source: Bloomberg, estimates by BRE Bank Securities

Earnings Forecast and Valuation

Based on DCF analysis (relative valuation is very sensitive to net profit changes driven by changes in the USD/PLN rate at the end of each reporting period, which reduces the reliability of the P/E multiple), we set the price target for Lotos at PLN 27.4 per share and we are upgrading the stock from sell to reduce.

DCF Valuation

DCF Model Assumptions

1. Our DCF model is based on cash flows generated by the Lotos Group excluding Petrobaltic, which we value separately.
2. Cash flows are discounted to their present value as at 31 July 2011. When calculating equity value, we took into account net debt as of 31 December 2010 plus current net hedging payables (mainly swaps and interest rate hedges).
3. The macroeconomic assumptions are as outlined above. The model factors in the upcoming changes in strategic reserve regulations which are the source of the high working capital flows in the forecast years (terminal value calculations are based on adjusted inventory flows).
4. We add the estimated value of the stake in Petrobaltic (PLN 11.7/share including the Yme project in Norway and Geonafta) to equity value.
5. The depreciation and amortization expenses projected for FY2020 are higher than CAPEX, which is unsustainable in the long term, prompting a D&A revision to PLN 406.6m.
6. When calculating FCF_{TV}, we based the terminal value calculations on the sales growth rate and EBITDA margins projected for 2020.
7. We assume that FCF will grow at a rate of 1% after 2020. The risk-free rate is 5.6%, and beta is 1.

DCF Model

(PLN m)	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F	2020F	2020+
Revenue	**27 091**	**27 427**	**26 476**	**25 524**	**25 518**	**25 512**	**25 500**	**25 500**	**25 500**	**25 500**	**25 500**
change	*37.7%*	*1.2%*	*-3.5%*	*-3.6%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
EBITDA	**1 345.9**	**1 039.7**	**1 150.8**	**1 118.9**	**1 091.6**	**1 087.5**	**1 078.0**	**1 078.2**	**1 078.0**	**1 088.5**	**1 088.5**
EBITDA margin	*5.0%*	*3.8%*	*4.3%*	*4.4%*	*4.3%*	*4.3%*	*4.2%*	*4.2%*	*4.2%*	*4.3%*	*4.3%*
D&A expenses	534.8	579.0	587.6	568.2	577.3	583.3	591.7	607.8	605.6	605.6	406.6
EBIT	**811.1**	**460.7**	**563.2**	**550.7**	**514.3**	**504.1**	**486.3**	**470.3**	**472.4**	**482.9**	**681.9**
EBIT margin	*3.0%*	*1.7%*	*2.1%*	*2.2%*	*2.0%*	*2.0%*	*1.9%*	*1.8%*	*1.9%*	*1.9%*	*2.7%*
Tax on EBIT	154.1	87.5	107.0	104.6	97.7	95.8	92.4	89.4	89.8	91.8	129.6
NOPLAT	**657.0**	**373.2**	**456.2**	**446.1**	**416.6**	**408.4**	**393.9**	**381.0**	**382.6**	**391.2**	**552.4**
CAPEX	-402	-406	-394	-407	-407	-407	-407	-407	-407	-407	-407
Working capital	-415.8	246.4	-33.0	345.3	343.6	343.6	343.7	343.6	343.6	344.3	0.0
Equity investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
FCF	**374.1**	**792.4**	**617.0**	**952.6**	**930.6**	**928.5**	**922.6**	**925.8**	**925.2**	**934.5**	**552.4**
WACC	*8.5%*	*8.7%*	*8.8%*	*9.1%*	*9.4%*	*9.8%*	*9.8%*	*9.8%*	*9.8%*	*9.8%*	*9.8%*
discount factor	*96.7%*	*88.9%*	*81.7%*	*74.9%*	*68.5%*	*62.4%*	*56.8%*	*51.7%*	*47.1%*	*42.9%*	*42.9%*
PV FCF	361.7	704.7	504.3	713.7	637.2	579.0	523.9	478.8	435.7	400.7	

	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F	2020F	2020+
WACC	***8.5%***	***8.7%***	***8.8%***	***9.1%***	***9.4%***	***9.8%***	***9.8%***	***9.8%***	***9.8%***	***9.8%***	***9.8%***
Cost of debt	*6.6%*	*6.6%*	*6.6%*	*6.6%*	*6.6%*	*6.6%*	*6.6%*	*6.6%*	*6.6%*	*6.6%*	*6.6%*
Risk-free rate	*5.60%*	*5.60%*	*5.60%*	*5.60%*	*5.60%*	*5.60%*	*5.60%*	*5.60%*	*5.60%*	*5.60%*	*5.60%*
Risk premium	*1.0%*	*1.0%*	*1.0%*	*1.0%*	*1.0%*	*1.0%*	*1.0%*	*1.0%*	*1.0%*	*1.0%*	*1.0%*
Effective tax rate	*19.0%*	*19.0%*	*19.0%*	*19.0%*	*19.0%*	*19.0%*	*19.0%*	*19.0%*	*19.0%*	*19.0%*	*19.0%*
Net debt / EV	*40.4%*	*36.2%*	*34.0%*	*28.8%*	*22.7%*	*15.0%*	*15.0%*	*15.0%*	*15.0%*	*15.0%*	*15.0%*
Cost of equity	*10.6%*	*10.6%*	*10.6%*	*10.6%*	*10.6%*	*10.6%*	*10.6%*	*10.6%*	*10.6%*	*10.6%*	*10.6%*
Risk premium	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*
Beta	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0

FCF growth after the forecast horizon	*1.0%*
Terminal value (TV)	6 268.3
Present value of terminal value (PV TV)	2 688.1
Present value of FCF in the forecast period	5 339.6
Enterprise value (EV)	8 027.7
Net debt	6 237.0
Equity value	1 790.8
Number of shares (millions)	129.9
Equity value per share ex Petrobaltic (PLN)	**13.8**
Per-share value of the stake in Petrobaltic	**11.7**
Final value per share	**25.4**
9M cost of equity	8.2%
Target Price	**27.4**
EV/EBITDA('10) for the target price	6.8
P/E('10) for the target price	5.2
TV / EV (refining business)	33%

Sensitivity Analysis

	FCF growth in perpetuity				
	0.0%	**1.0%**	**2.0%**	**3.0%**	**4.0%**
WACC +1.0pp	23.3	25.2	27.4	30.3	34.0
WACC +0.5pp	24.2	26.2	28.8	32.0	36.3
WACC	25.2	27.4	30.3	34.0	39.0
WACC -0.5pp	26.2	28.8	32.0	36.3	42.1
WACC -01.0pp	27.4	30.3	34.0	39.0	46.0

Relative Valuation

		P/E				EV/EBITDA			
	Price	2010	2011F	2012F	2013F	2010	2011F	2012F	2013F
MOL	16750.0	10.0	7.0	6.9	5.9	5.8	4.5	4.3	4.1
OMV	24.3	6.6	6.4	5.4	5.0	3.5	3.2	2.9	2.7
PKN**	37.2	6.7	7.2	9.7	8.9	4.2	4.3	5.2	5.0
Tupras	35.6	10.5	9.0	8.4	8.8	5.8	5.2	4.9	4.7
Hellenic	5.4	9.1	7.7	5.3	4.5	8.1	7.5	5.9	5.5
Unipetrol (CZK)	172.0	21.2	53.1	121.0	35.5	6.0	6.2	6.1	5.1
SNP Petrom	0.3	7.7	4.9	4.7	4.4	3.7	2.7	2.7	2.6
ERG	8.1	-98.6	83.8	12.9	10.1	8.6	8.0	5.5	5.0
Neste	7.1	14.7	10.8	6.3	4.9	9.0	6.7	5.4	4.8
Motor Oil	6.5	8.3	5.9	5.7	5.3	7.4	5.7	5.6	5.7
INA	4191.2	29.4	9.4	7.5	7.6	12.0	6.6	5.6	5.7
Maximum		29.4	83.8	121.0	35.5	12.0	8.0	6.1	5.7
Minimum		-98.6	4.9	4.7	4.4	3.5	2.7	2.7	2.6
Median		**9.1**	**7.7**	**6.9**	**5.9**	**6.0**	**5.7**	**5.4**	**5.0**
Lotos*	30.3	5.8	4.8	9.6	7.8	7.0	6.4	6.8	5.9
(premium / discount)		-34.1%	-38.1%	39.2%	33.4%	17.5%	12.5%	25.3%	20.0%
Implied value									
Median		9.1	7.7	6.9	5.9	6.0	5.7	5.4	5.0
Multiple weight			50.0%				50.0%		
Year weight		0.0%	33.3%	33.3%	33.3%	0.0%	33.3%	33.3%	33.3%
Value per share (PLN)		**24.5**							

**EV/EBITDA based on FY2010 net debt*

***PKN's net debt adjusted for Polkomtel holdings*

Income Statement

(PLN m)		2007	2008	2009	2010	2011F	2012F	2013F
Revenue		**13 125.1**	**16 294.7**	**14 321.0**	**19 680.5**	**27 650.3**	**28 326.4**	**27 538.4**
change		*2.6%*	*24.1%*	*-12.1%*	*37.4%*	*40.5%*	*2.4%*	*-2.8%*
EBIT		**713.7**	**-145.8**	**419.8**	**1 061.4**	**1 008.3**	**776.0**	**983.2**
Refineries		617.0	-298.0	389.3	989.5	848.2	465.8	533.9
	incl. LIFO effect	393.3	-612.1	448.1	418.5	377.7	-153.6	-54.0
upstream		134.0	188.0	-6.7	24.7	197.3	315.3	420.0
Retail		-50.0	-14.0	55.6	13.9	-37.4	-5.5	29.3
Other		12.7	-21.8	-18.4	33.3	0.3	0.4	0.1
LIFO EBIT		**320.4**	**466.3**	**-28.3**	**642.9**	**630.6**	**929.5**	**1 037.2**
EBIT		**713.7**	**-145.8**	**419.8**	**1 061.4**	**1 008.3**	**776.0**	**983.2**
change		*-10.6%*	*-120.4%*	*-387.9%*	*152.8%*	*-5.0%*	*-23.0%*	*26.7%*
EBIT margin		*5.4%*	*-0.9%*	*2.9%*	*5.4%*	*3.6%*	*2.7%*	*3.6%*
Financing income/expenses		268.6	-384.4	651.0	-358.1	7.6	-120.4	-126.0
Extraordinary gains/losses		0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other		22.3	26.6	38.8	18.7	0.0	0.0	0.0
Pre-tax income		**1 004.5**	**-503.7**	**1 109.6**	**722.0**	**1 015.9**	**655.6**	**857.2**
Tax		190.3	-114.3	197.8	40.6	188.1	245.9	352.9
Minority interests		37.0	64.1	11.0	2.2	0.0	0.0	0.0
Net income		**777.2**	**-453.5**	**900.8**	**679.2**	**827.9**	**409.7**	**504.3**
change		*14.3%*	*-158.4%*	*-298.6%*	*-24.6%*	*21.9%*	*-50.5%*	*23.1%*
margin		*5.9%*	*-2.8%*	*6.3%*	*3.5%*	*3.0%*	*1.4%*	*1.8%*
D&A expenses		306.2	315.0	284.8	389.9	598.2	725.7	734.4
EBITDA		**1 019.9**	**169.2**	**704.6**	**1 451.3**	**1 606.5**	**1 501.7**	**1 717.6**
change		*-6.9%*	*-83.4%*	*316.5%*	*106.0%*	*10.7%*	*-6.5%*	*14.4%*
EBITDA margin		*7.8%*	*1.0%*	*4.9%*	*7.4%*	*5.8%*	*5.3%*	*6.2%*
Shares at year-end (millions)		113.7	113.7	129.9	129.9	129.9	129.9	129.9
EPS		6.8	-4.0	6.9	5.2	6.4	3.2	3.9
CEPS		9.5	-1.2	9.1	8.2	11.0	8.7	9.5
ROAE		*14.2%*	*-8.1%*	*14.8%*	*9.5%*	*10.5%*	*4.8%*	*5.7%*
ROAA		*8.9%*	*-4.1%*	*6.6%*	*4.1%*	*4.5%*	*2.2%*	*2.7%*

Balance Sheet

(PLN m)	2007	2008	2009	2010	2011F	2012F	2013F
ASSETS	**9 720.4**	**12 187.6**	**15 226.0**	**17 736.0**	**19 045.2**	**18 880.5**	**18 755.0**
Fixed assets	**4 508.1**	**7 102.3**	**10 106.6**	**10 888.3**	**10 991.9**	**10 972.3**	**10 931.8**
Property, plant and equipment	4 253.0	6 733.3	9 678.9	10 387.5	10 486.8	10 465.1	10 424.8
Intangible assets	65.0	55.9	89.2	94.8	99.1	101.2	101.0
Goodwill	58.2	45.6	46.7	46.7	46.7	46.7	46.7
Long-term investments	73.5	113.3	185.1	160.8	160.8	160.8	160.8
Other	58.4	154.1	106.6	198.5	198.5	198.5	198.5
Current assets	**5 212.3**	**5 085.3**	**5 119.4**	**6 847.7**	**8 053.3**	**7 908.2**	**7 823.2**
Inventories	2 589.3	2 447.2	3 023.1	4 506.8	5 028.1	4 812.1	4 809.6
Current receivables	1 542.5	1 364.9	1 536.9	1 821.9	2 212.0	2 266.1	2 203.1
Other	155.5	560.4	204.3	127.7	127.7	127.7	127.7
Cash and cash equivalents	925.0	712.8	355.1	391.3	685.5	702.3	682.7

(PLN m)	2007	2008	2009	2010	2011F	2012F	2013F
EQUITY AND LIABILITIES	**9 720.4**	**12 187.6**	**15 226.0**	**17 736.0**	**19 045.2**	**18 880.5**	**18 755.0**
Equity	**5 816.2**	**5 389.5**	**6 809.4**	**7 498.8**	**8 326.7**	**8 736.4**	**9 035.8**
Share capital	113.7	113.7	129.9	129.9	129.9	129.9	129.9
Other	5 702.5	5 275.8	6 679.5	7 368.9	8 196.8	8 606.5	8 905.9
Minority interests	**334.7**	**396.1**	**36.8**	**14.7**	**14.7**	**14.7**	**14.7**
Long-term liabilities	**1 215.6**	**3 876.1**	**5 660.8**	**5 066.6**	**5 056.7**	**4 598.7**	**4 371.8**
Loans	842.9	3 412.2	4 942.6	4 403.5	4 393.6	3 935.6	3 708.7
Other	372.7	463.8	718.2	663.1	663.1	663.1	663.1
Current liabilities	**2 353.8**	**2 525.9**	**2 719.0**	**5 156.0**	**5 647.2**	**5 530.8**	**5 332.7**
Loans	517.2	507.4	758.5	1 932.0	1 927.7	1 726.7	1 627.2
Trade creditors	1 757.5	1 886.4	1 890.7	2 960.8	3 456.3	3 540.8	3 442.3
Other	79.2	124.0	58.0	195.4	195.4	195.4	195.4

Debt*	1 360.1	3 919.6	5 701.1	6 335.5	6 561.3	5 902.4	5 575.9
Net debt	435.1	3 206.8	5 346.0	5 944.2	5 875.7	5 200.1	4 893.1
(Net debt / Equity)	*7.5%*	*59.5%*	*78.5%*	*79.3%*	*70.6%*	*59.5%*	*54.2%*
(Net debt / EBITDA)	0.4	19.0	7.6	4.1	3.7	3.5	2.8
BVPS	51.2	47.4	52.4	57.7	64.1	67.3	69.6

** FY2010 net debt plus current amounts payable under open hedging positions*

Cash Flows

(PLN m)	2007	2008	2009	2010	2011F	2012F	2013F
Cash flow from operating activities	**157.8**	**311.7**	**695.0**	**880.3**	**1 002.6**	**1 502.2**	**1 331.6**
Net income	777.2	-453.5	900.8	679.2	827.9	409.7	504.3
D&A expenses	306.2	315.0	284.8	389.9	598.2	725.7	734.4
Working capital	-882.9	197.4	-70.5	-625.7	-415.8	246.4	-33.0
Other	-42.7	252.8	-420.0	436.9	-7.6	120.4	126.0
Cash flow from investing activities	**-816.4**	**-2 417.1**	**-3 333.6**	**-1 053.9**	**-513.7**	**-584.8**	**-598.0**
CAPEX	-1 050.3	-2 478.5	-3 331.2	-1 067.0	-701.8	-706.2	-693.8
Equity investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	233.8	61.4	-2.4	13.1	188.1	121.3	95.8
Cash flows from financing activities	**513.1**	**1 963.1**	**2 181.5**	**447.7**	**-194.7**	**-900.6**	**-753.2**
Stock issue	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt	556.6	2 266.3	2 068.1	631.8	-14.2	-658.9	-326.5
Dividend (buy-back)	-40.9	0.0	0.0	0.0	0.0	0.0	-204.8
Other	-34.1	-303.2	-102.7	-286.7	-180.5	-241.7	-221.8
Change in cash	**-147.1**	**-138.8**	**-454.8**	**272.1**	**294.3**	**16.8**	**-19.5**
Cash at period-end	925.0	712.8	355.1	391.3	685.5	702.3	682.7
DPS (PLN)	0.36	0.00	0.00	0.00	0.00	0.00	1.58
FCF	-1 103.6	-1 997.6	-2 895.0	-282.0	300.8	796.0	637.8
(CAPEX / Sales)	*8.0%*	*15.2%*	*23.3%*	*5.4%*	*2.5%*	*2.5%*	*2.5%*

Market Multiples

	2007	2008	2009	2010	2011F	2012F	2013F
P/E	4.4	-7.6	4.4	5.8	4.8	9.6	7.8
P/CE	3.2	-24.9	3.3	3.7	2.8	3.5	3.2
P/BV	0.6	0.6	0.6	0.5	0.5	0.5	0.4
P/S	0.3	0.2	0.3	0.2	0.1	0.1	0.1
FCF/EV	*-26.2%*	*-28.3%*	*-31.1%*	*-2.8%*	*3.1%*	*8.7%*	*7.2%*
EV/EBITDA	4.1	41.7	13.2	6.8	6.1	6.1	5.2
EV/EBIT	5.9	-48.4	22.2	9.3	9.7	11.8	9.0
EV/S	0.3	0.4	0.7	0.5	0.4	0.3	0.3
DYield	*1.2%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*5.2%*

Price (PLN)	**30.33**						
Shares at year-end (millions)	113.7	113.7	129.9	129.9	129.9	129.9	129.9
MC (PLN m)	3448.5	3448.5	3939.1	3939.1	3939.1	3939.1	3939.1
Equity attributable to minority shareholders (PLN m)	334.7	396.1	36.8	14.7	14.7	14.7	14.7
EV (PLN m)	4 218.4	7 051.4	9 321.8	9 897.9	9 829.4	9 153.8	8 846.8

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List of abbreviations and ratios contained in the report:
EV *– net debt + market value*
EBIT *– Earnings Before Interest and Taxes*
EBITDA *– EBIT + Depreciation and Amortisation*
P/CE *– price to earnings with amortisation*
MC/S *– market capitalisation to sales*
EBIT/EV *– operating profit to economic value*
P/E *– (Price/Earnings) – price divided by annual net profit per share*
ROE *– (Return on Equity) – annual net profit divided by average equity*
P/BV *– (Price/Book Value) – price divided by book value per share*
Net debt *– credits + debt papers + interest bearing loans – cash and cash equivalents*
EBITDA margin *– EBITDA/Sales*

Recommendations of BRE Bank Securities
A recommendation is valid for a period of 6-9 months, unless a subsequent recommendation is issued within this period. Expected returns from individual recommendations are as follows:
BUY – we expect that the rate of return from an investment will be at least 15%
ACCUMULATE – we expect that the rate of return from an investment will range from 5% to 15%
HOLD – we expect that the rate of return from an investment will range from –5% to +5%
REDUCE – we expect that the rate of return from an investment will range from -5% to -15%
SELL – we expect that an investment will bear a loss greater than 15%
Recommendations are updated at least once every nine months.

Strong and weak points of valuation methods used in recommendations:
DCF – acknowledged as the most methodologically correct method of valuation; it is based in discounting financial flows generated by a company; its weak point is the significant susceptibility to a change of forecast assumptions in the model.
Comparative – based on a comparison of valuation multipliers of companies from a given sector; simple in construction, reflects the current state of the market; weak points include substantial variability (fluctuations together with market indices) as well as difficulty in the selection of the group of comparable companies.

Previous ratings issued for Lotos

Rating	Sell
Date issued	2011-01-18
Price on rating day	38.49
WIG on rating day	47457.37